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<b>UTILITY PATENT APPLICATION TRANSMITTAL</b> <i>(Only for new nonprovisional applications under 37 CFR 1.53(b))</i>	Attorney Docket No.	10366-013	Total Pages	64
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<b>APPLICATION ELEMENTS</b> See MPEP chapter 600 concerning utility patent application contents.	<b>ADDRESS TO:</b> Assistant Commissioner for Patents Box Patent Application Washington, DC 20231
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8. ☒ Assignment Papers (cover sheet + copy & document(s))
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ATTORNEY DOCKET NO. 10366-013Date: November 21, 2000

Assistant Commissioner for Patents  
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Sir:

The following utility patent application is enclosed for filing:

Applicant(s): Müller et al.

Executed on: November 15 &amp; 16, 2000

Title of Invention: Method for Creating and Pricing Options

**PATENT APPLICATION FEE VALUE**

TYPE	NO. FILED	LESS	EXTRA	EXTRA RATE	FEE
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- ☐ Priority of application no. filed on in is claimed under 35 U.S.C. § 119.  
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Respectfully submitted,

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# METHOD FOR CREATING AND PRICING OPTIONS

## Field of the Invention

The subject invention is directed to option creation and pricing, and more particularly to creation and pricing of options on an asset whose value over time is graphically displayed on a computer screen.

## Background

An option is a contract that gives its owner the right to buy or sell some asset at a pre-specified price. See Zvi Bodie and Robert C. Merton, Finance, 384 (2000). An option to buy the specified item at a fixed price is a call; an option to sell is a put. The buy or sell price specified in an option contract is called the option's strike price or exercise price. The date after which an option can no longer be exercised is called its expiration date or maturity date. An American-type option can be exercised at any time up to and including the expiration date. A European-type option can only be exercised on the expiration date.

Options on stocks were first traded on an organized exchange in 1973. See John C. Hull, Options, Futures and Other Derivatives 5 (1999) (hereinafter Hull). European and American options on foreign currencies are now actively traded in both over-the-counter and exchange-traded markets. The Philadelphia Stock Exchange has been trading currency options since 1982.

Pricing formulas for call options are known. For example, the Black-Scholes-Merton formula states that the price  $C$  of a European-type call option for a stock can be calculated at any time before the option matures by the following:

$$C = SN(d_1) - Le^{-rT}N(d_1 - \sigma\sqrt{T}),$$

where  $S$  is the current price – the price at which the stock underlying the call option is trading.  $N(d)$  is the probability that a random draw from a standard normal distribution will be less than  $d$ .  $d_1$  is given by the formula:

$$d_1 = \frac{\ln\left(\frac{S}{E}\right) + \left(r + \frac{\sigma^2}{2}\right)T}{\sigma\sqrt{T}}$$

where  $S$  = price of the stock;  $E$  = exercise price;  $r$  = risk-free interest rate (the annualized, continuously-compounded rate on a safe asset with the same maturity as the option);  $\sigma$  = the volatility of the stock—that is, the standard deviation of the annualized, continuously-compounded rate of return on the stock;  $T$  = time to maturity of the option in years;  $L$  is the exercise price—the price at which the holder has the right to buy the stock when the call option expires; and  $e^{-rT}$  is a term that adjusts the exercise price,  $L$ , by taking into account the time value of money.

Other, generally more complicated, formulas exist for option pricing. The nature of the problem dictates that they depend on the probability that the price of the asset will reach a certain level in a certain period of time. This probability in turn is a function of the current asset price and the volatility (current and/or predicted) of the asset price. A high volatility increases the probability than a given asset price will be reached.

As is known to those skilled in the art, options generally and option pricing methods in particular are not user-friendly: novice investors find them arcane and intimidating, and consequently avoid using them.

There is thus a need for a user-friendly, efficient, intuitively simple type of option. Such an option should be sophisticated enough to be interesting to experienced traders, yet user-friendly enough for a novice to use. Similarly, there is a need for a method and system that allows a novice user to create and select the parameters of such an option without needing to understanding the mathematics or financial theory behind the option.

## Summary

A preferred embodiment of the subject invention is directed to creation and pricing of an option related to a target zone in a time-price plot. If the price curve against time enters this zone (in a preferred embodiment, a “box”), a fixed amount of money is paid to the owner of the option; if the curve misses the box, there is no payout to the option owner, who also forfeits the premium paid for the option. Software is described that enables an option buyer to easily create and set the parameters of such an option, that computes



## 1. Introduction

In a preferred embodiment, the options are rectangular boxes defined in a price-time plot. Such a plot is shown as the dark area in the display of **FIG. 1**, where price is plotted on the vertical axis and time on the horizontal axis. A box option is depicted in **FIG. 1** as rectangle **130**. In alternate embodiments, options have other shapes.

A preferred pricing algorithm is based on high-frequency data technology. As is true for all option types, binomial trees can be used to approximately compute option prices. However, this is not necessary in the case of rectangular box options, as will be shown below.

## 2. Hitting the box

A box option can be hit in one of three ways: either at the front of the box (at its start-time) (see **FIGS. 1** and **5**), or from the lower (see **FIG. 4**) or upper side (see **FIG. 6**) (at a time between the start-time and end-time). This is also illustrated in **FIG. 3**. “Cutting a corner” counts as a hit, even if no price point actually occurs in the box.

As soon as the box is hit, the payout is due and the box option no longer exists. This is known as “early exercising” in the option pricing art. The option lasts until the end time of the box only if the price curve misses the box.

The different ways of hitting the box correspond to different pricing methods. The probability of hitting at the front is simply the integral of the probability distribution at start time, taken over the price range of the box. Computing the probability of entering through the upper or lower limit is more demanding but possible; a preferred embodiment uses a method based on Zumbach, G.O., Considering Time as the Random Variable: The First Hitting Time, Neural Network World, 3, 243-253 (1998) (Zumbach, 1998), discussed below in section 4.

If the target zone of the option is not a box but, for example, a circle, or a set of many boxes, the situation becomes more complicated. In such a case, hitting the front and hitting the top or bottom are not as easily distinguishable as for a box. The preferred methodology in such a case is the use of binomial (or trinomial) trees (see Section 8, below).

## 3. Basic ingredients

One goal of the subject invention is to achieve a pricing formula with reasonable precision. A danger to be avoided is over-engineering of the algorithm. In principle, almost all the problems of mathematical finance have an influence on the pricing, but we cannot solve all open research problems before specifying the pricing algorithm.

Therefore, the most important ingredients and effects have to be identified and efficiently modeled. These are the main ingredients addressed by a preferred embodiment:

- Spot price data. We need a raw data input.
- Daily and weekly seasonality of volatility. Ignoring this can easily lead to mispricing.
- Volatility forecasting. The quality of volatility forecasts almost directly defines the quality of computed option premiums.
- Announcements. Financial announcements may cause a volatility shock affecting the option premium.
- Heavy tails of the distribution function of returns. The hitting probability of boxes placed far in-the-money or out-of-the-money strongly depends on the behavior of extreme returns.
- Micro-oscillations. In high time resolution (e.g., minutes), small, mean-reverting price oscillations occur on top of the normal price process. These oscillations lead to higher hitting probabilities.
- Interest on the invested capital and interest rate differentials.

A preferred embodiment of the subject method can compute probability estimates for reaching any infinitesimal spot of the price-time plane. This is an intermediary result on the way to computing the hitting probability of finite boxes. An evaluation of the effects discussed above shows that one can expect to have errors of about 20% of local probability estimates. Thus we ignore subtle effects affecting the probability estimates by less than, say, 5%.

Once we have the volatility forecast, we compute the probability estimates for any infinitesimal spot of the price-time plane, assuming a Brownian motion of the logarithm

of price over  $\vartheta$ -time (discussed below in Section 3.3), modified by a heavy-tail correction. From this, we compute the probability of entering the box.

### 3.1 Spot price data

A preferred embodiment requires a raw data input. In order to price the box option, we need the starting point: the price “now.” A data input is also indirectly needed as a basis of the volatility forecast (see Section 3.3). The price data may come from any source. In the case of options on foreign exchange (FX) rates, the most convenient data source for a system is the time series of middle prices generated by a system’s own market making in the FX spot market. In the description herein of preferred embodiments, data is simply assumed to be available.

It should be noted that the methods described herein are applicable to data other than FX data. Any data that can be displayed in a time chart, such as the price of butter, or the temperature in Madrid, can also serve as a basis (an “asset”) for the disclosed options. The term “asset” is thus used herein to refer to any quantity whose value is time-dependent.

### 3.2 Seasonality of volatility

Ignoring daily and weekly seasonality of volatility can easily lead to volatility errors of a factor of two, and to similar pricing errors. A time scale that takes seasonality effects into account, such as “ $\vartheta$ -time” (see Dacarogna et al., A Geographical Model for the Daily and Weekly Seasonal Volatility in the FX Market, Journal of International Money and Finance, 12(4), 413-438 (Dacarogna 1993), is a useful tool for minimizing such errors, and is used in a preferred embodiment.

### 3.3 Volatility forecast

A forecast is required for the volatility of the relevant period of the option: from “now” until the end-time of the box. Implied volatility figures and the well-known Risk-Metrics method are too slow and inert and suffer from an unacceptably high forecasting error. A good volatility forecast should also use some fast intra-day information. Even a good volatility forecast may have an error of, say, 15% of the resulting forecast value.

The expected error of the volatility forecast is also a variable of interest. The true volatility in the future is expected to be approximately log-normally distributed about a



mean. Therefore, we assess mean and standard deviation of  $\log(\text{volatilityForecast})$ . The standard deviation is in general larger for intra-day than for long-term volatility forecasts. The expected standard deviation is closely related to the heavy tails of the expected distribution function of returns, as discussed below in section 3.5.

5           A preferred embodiment also considers local heteroskedasticity (fluctuations of the assumed volatility inside the period), when the option period is long. Also, the sudden volatility shock due to financial announcements is taken into account; see section 3.4.

Herein we assume that volatility forecasts are just an external input, so their computation is outside the scope of this description.

### 10           **3.4 Announcements**

There are some scheduled days for financial announcements such as the release of key economic figures. Some economic figures, particularly unexpected ones, lead to price and volatility outbursts that strongly affect the volatility and the pricing of the box option. Announcement shocks are not too frequent, but when they happen, they can lead to pricing errors of a factor of two or more.

15           To take into account such announcement shocks, a preferred embodiment uses a safety factor in the final pricing formula, either initiated by human intervention or following standard assumptions on likely days and times of announcements.

### **3.5 Heavy tails**

20           The distribution function of returns has heavy tails. If the box of the option is located in an extreme region of the price-time plane, the hitting probability is very low. When assuming a Brownian motion of (logarithmic) prices, we underestimate this probability and the necessary premium to cover the risk. We need a model of the heavy tails, to avoid dangerous underpricing.

25           One way to understand heavy tails is to explain them by an uncertainty of volatility. This means that we assume a Gaussian behavior of returns in the near future but we do not exactly know the volatility. We have a volatility forecast, but the true volatility in the near future is assumed to deviate from this forecast. This assumption can be seen as equivalent to assuming a perfectly known volatility with a heavy-tailed distribution

30           function: a mixture of normal distributions with different variances.

A preferred embodiment models this by computing the box hitting probability for different volatility assumptions (scenarios) in the future – each such assumption with its own probability. The assumed volatility values are centered around the volatility forecast, but we also need an assumption on typical deviations of future volatility from this volatility forecast.

Example for a  $\log(\text{volatility})$  forecast of  $\log(10\%)$ : Explore four different volatilities according to Hermite integration for  $\log(\text{volatility})$ :

1. Volatility = 7.2% with weight 0.05
2. Volatility = 9.0% with weight 0.45
3. Volatility = 11.1% with weight 0.45
4. Volatility = 13.9% with weight 0.05

We already have a log-normal model of volatility (see section 3.3). This fits nicely with our modeling of heavy tails. Obtaining realistic tails of the return distribution is important for the realistic pricing of options with boxes located far from the current spot price.

When the box hitting probabilities of all volatility scenarios are known, the additivity of probabilities is applied. The resulting overall box hitting probability is the mean of the different box hitting probabilities, each weighted by the probability of the respective scenario.

Some of the announcement shocks that are not modeled explicitly are implicitly accounted for through the modeling of heavy tails.

### 3.6 Micro-oscillations

In high time-resolution (e.g., minutes), small, mean-reverting price oscillations occur on top of a price process, similar to a Brownian motion. These oscillations are known to cause a bias in volatility measurements. They may appear not only in multi-contributor markets but also in a preferred system's own spot price; their size depends on the market and the data source.

The micro-oscillations lead to a higher box-hitting probability, and thus should be accounted for. In a preferred embodiment, a box of increased vertical extension is used, unless the box has a duration too short to be affected by micro-oscillations. A reasonable

assumption is:

$$\text{Extension} = 0.04 \frac{\Delta t}{\Delta t + 0.0006} \text{SizeOfOneDayMove} \quad (1)$$

where  $\Delta t$  is the duration of the box in days of the chosen time scale (e.g.,  $\vartheta$ -time). The extension is quantified here as a small multiple of the typical size of a price change in one day. The parameters of the formula can be modified, within limits recognized by those skilled in the art. The extension should be made on both sides of the price range of the box.

### 3.7 Interest rate effects

A box option has a nontrivial lifespan. Therefore, interest on the invested capital and the interest differential between the two underlying currencies have an influence on the pricing of the option. A preferred embodiment takes these effects into account:

- Interest on the invested capital. The option buyer has to pay the option premium to a preferred system's margin account. There, it earns some interest according to the technical nature of that margin account, until the option expires.
- Interest rate differential. An option with a box higher than the current price behaves a bit like an ordinary call option. Therefore, it has a positive "delta" (derivative of premium against spot price). A box lower than the current price leads to a negative delta. Options with nonzero delta locally behave like investments in the underlying instrument, so the interest differential is significant. Smart customers could exploit this small effect to the disadvantage of an operator of a preferred system. Thus:
  - A preferred embodiment uses only major rates with low interest differentials and limits the lifetime of the option to a few weeks. Thus, the effect of interest differentials on pricing becomes negligible.
  - An alternate embodiment fully integrates the interest differential into the pricing method (not only superficially, but also assuming a Brownian motion around the forward rate instead of the current spot rate).

## 4 Direct Solution

A preferred embodiment prices a box option directly (i.e., without a binomial tree) using a result from (Zumbach 1998).

#### 4.1 Equations of the hitting probabilities

5 We assume a box option with start-time  $t_s$ , end-time  $t_e = t_s + \Delta t$ , lower price limit  $x_a$ , upper price limit  $x_b$  (see **FIG. 4**). With no loss of generality, the solution is derived with the time definition  $t = 0$  at time “now” (the time of the pricing); similarly, we assume  $x(0) = 0$  for the logarithmic mid-price.

10 The symbol  $t$  stands for the chosen time scale, whatever it is. A preferred embodiment uses a  $\vartheta$ -time scale (see section 3.2). However, other time scales are also acceptable, as those skilled in the art will recognize (see section 7.3 below).

At this point, we assume only one volatility level  $\sigma$ , and Brownian motion within one scenario (see section 3.5).

At time  $t_s$ , three different things are possible:

- 15 1.  $x(t_s) > x_b$ . We are above the box; the only possibility of hitting the box is to hit it *first* through the *upper limit* at  $x_b$ .
2.  $x_a \leq x(t_s) \leq x_b$ . We are hitting the box through its *front*, already at  $t_s$ .
3.  $x(t_s) < x_a$ . We are below the box; the only possibility of hitting the box is to hit it *first* through the *lower limit* at  $x_a$ .

20 There is no other case but these three cases, and no possible price curve belongs to two cases at the same time. Therefore, the total probability of hitting the box is the *sum* of the three hitting probabilities of the three cases.

25 Although the price curve  $x(t)$  is treated herein as if continuous, we only have discrete points in practice. Therefore, crossing of the whole box from above to below (or from below to above) is also regarded as “hitting.” This may happen for thin boxes where  $x_b$  is very close to  $x_a$ .

To determine the probability of the second case of the list, hitting through the front, we need to know the probability of arriving at a price  $x(t_s)$  between  $x_a$  and  $x_b$  for

a Brownian motion. This is

$$p_{\text{front}} = 0.5 \left[ \Phi \left( \frac{x_b}{\sigma \sqrt{t_s}} \right) - \Phi \left( \frac{x_a}{\sigma \sqrt{t_s}} \right) \right] \quad (2)$$

where  $\Phi$  is the error function:

$$\Phi(u) = \frac{2}{\sqrt{2\pi}} \int_0^u e^{-\frac{v^2}{2}} dv \quad (3)$$

5           The first and third cases of the list are more complicated. The first case, hitting through the upper limit, is treated as follows. The probability of hitting the infinitesimal interval between  $x(t_s) = x_s$  and  $x(t_s) = x_s + dx$  is  $[1/(\sqrt{2\pi t_s} \sigma)] \exp[-(x^2)/(2\sigma^2 t_s)] dx$ . If we are in this case, the total probability of hitting the box through the upper limit can be computed with the help of Equation (4) of (Zumbach 1998). It is

$$10 \quad p_{\text{upperLimit}, x(t_s)=x_s} = 1 - \Phi \left( \frac{x_s - x_b}{\sigma \sqrt{\Delta t}} \right) \quad (4)$$

This can be integrated over all possible start prices  $x_s > x_b$ . The resulting probability of hitting the box through the upper limit (starting from any  $x(t_s) > x_b$ ) is

$$p_{\text{upperLimit}} = \frac{1}{\sqrt{2\pi} \sigma \sqrt{t_s}} \int_{x_b}^{\infty} e^{-\frac{x^2}{2\sigma^2 t_s}} \left[ 1 - \Phi \left( \frac{x - x_b}{\sigma \sqrt{\Delta t}} \right) \right] dx \quad (5)$$

15           The third case of the list, hitting through the lower limit, is solved analogously to obtain

$$p_{\text{lowerLimit}} = \frac{1}{\sqrt{2\pi} \sigma \sqrt{t_s}} \int_{-\infty}^{x_a} e^{-\frac{x^2}{2\sigma^2 t_s}} \left[ 1 - \Phi \left( \frac{x_a - x}{\sigma \sqrt{\Delta t}} \right) \right] dx \quad (6)$$

Eqs. 5 and 6 cannot be analytically integrated in the general case. Numerical integration is required; a recipe is given in the next section.

## 4.2 Numerical integration of the hitting probability

20           The integral of eq. 5 extends to infinity. Its integrand rapidly goes to zero for extreme values of  $x$ , but it is not immediately clear where the integrand has its highest mass. Under these circumstances, numerical integration is not trivial. We need a method to carefully select a limited set of  $x$  values at which the integrand is evaluated.

25           To get an idea of the overall form of the integrand, we re-write the factor  $[1 - \Phi(.)]$  of eq. 5:

$$1 - \Phi(u) = f(u) e^{-\frac{(u+1)^2}{2}} \quad (7)$$

The last factor essentially defines the order of magnitude of  $[1 - \Phi(u)]$ . The first factor, the function  $f(u)$ , is a slowly-varying, smooth function that does not change its order of magnitude for any positive value of  $u$ .

Inserting eq. 7 into eq. 5 yields

$$p_{\text{upperLimit}} = \frac{1}{\sqrt{2\pi}\sigma\sqrt{t_s}} \int_{x_b}^{\infty} e^{-\frac{x^2}{2\sigma^2 t_s}} f\left[\left(\frac{x - x_b}{\sigma\sqrt{\Delta t}}\right)\right] e^{-\frac{(x - x_b + \sigma\sqrt{\Delta t})^2}{2\sigma^2 \Delta t}} dx \quad (8)$$

Now we see two factors of the Gaussian type in the integrand. The product of two Gaussian factors of the type  $\exp[-(x - a)^2/2b^2]$  can be shown to be a constant times a new Gaussian factor of the same type. This means that our integrand behaves similarly to a Gaussian bell curve. In fact, the sole purpose of our analysis is to demonstrate this fact and to approximately determine the mean and the variance of the new Gaussian bell curve. Then we know where the integrand has its mass.

From eq. 8, we obtain

$$p_{\text{upperLimit}} = \frac{1}{\sqrt{2\pi}\sigma\sqrt{t_s}} \int_{x_b}^{\infty} F\left[\left(\frac{x - x_b}{\sigma\sqrt{\Delta t}}\right)\right] e^{-\frac{(x - \mu')^2}{2\sigma'^2}} dx \quad (9)$$

The function  $F(u)$  is  $f(u)$  times a constant factor and thus has the same slowly varying properties as  $f(u)$ . We do not need to compute this. The main results are the mean and variance of the Gaussian factor of the integrand. The mean is

$$\mu' = \frac{t_s (x_b - \sigma\sqrt{\Delta t})}{t_s + \Delta t} \quad (10)$$

The variance is

$$\sigma'^2 = \sigma^2 \frac{t_s \Delta t}{t_s + \Delta t} \quad (11)$$

This means that the variance is smaller than the variance of either Gaussian factor of eq. 8. The mean  $\mu'$  lies between the means of the two Gaussian factors, closer to the mean of the narrower Gaussian factor.

Now we are ready to introduce an integration scheme. This should be centered around  $\mu'$  and be optimal for a normal distribution with variance  $\sigma'^2$ . At first sight, we might be tempted to use Hermite integration, as in the case of the volatilities of section 3.5. However, that integration scheme is suited to integrals from  $-\infty$  to  $\infty$  or from the

center of a Gaussian-like distribution to  $\infty$ . This is not the case here: one of the two integration limits can be anywhere.

Therefore, we have to choose an integration scheme with flexible limits. This can be done as follows. First, we make a monotonic coordinate transformation:

$$\xi = \xi(x) = \frac{x - \mu'}{\sqrt{4 \sigma'^2 + (x - \mu')^2}} \quad (12)$$

where  $\xi$  is confined between -1 and 1. The inverse transformation is

$$x = x(\xi) = \mu' + \frac{2 \sigma' \xi}{\sqrt{1 - \xi^2}} \quad (13)$$

Note that  $x$  is centered around  $\mu'$ , with  $\xi(\mu') = 0$ , as desired for a reasonable integration scheme. The derivative is

$$\frac{dx}{d\xi} = 2 \sigma' (1 - \xi^2)^{-1.5} \quad (14)$$

A transformation based on the Gaussian integral or exponential functions would also be appropriate but would not be analytically invertible and/or would lead to more complicated expressions.

The idea is to integrate over  $\xi$  rather than  $x$ . The upper integration limit ( $x = \infty$ ) becomes finite:  $\xi = 1$ . Thus the integration is over a finite interval, for which Gaussian integration is optimal. The formula for any integrable function  $g(x)$  (see Table 25.4, Abscissas and Weight Factors for Gaussian Integration, of Abramowitz, M. and Stegun, A., Handbook of Mathematical Functions, (9th ed. 1970) (A & S 1970)) is:

$$\int_a^b g(x) dx = 2 \sigma' \int_{\xi(a)}^{\xi(b)} g[x(\xi)] (1 - \xi^2)^{-1.5} d\xi \quad (15)$$

where eq. 14 has been used. The new factor  $(1 - \xi^2)^{-1.5}$  becomes very large when  $\xi$  approaches 1 or  $-1$ . The integral behaves well because the factor  $g[x(\xi)]$  goes to zero even more quickly (exponentially, as already shown in eq. 9).

The next task is to insert the integrand of eq. 5 as the function  $g(x)$  and to numerically integrate over the finite  $\xi$  interval from  $\xi(x_b)$  to 1, using Gaussian integration. Details are explained in section 7.

After computing  $p_{\text{upperLimit}}$ , the probability  $p_{\text{lowerLimit}}$  is calculated by an analogous integration method.

### 4.3 The total box hitting probability

The total box hitting probability is now the sum:

$$p = p_{\text{front}} + p_{\text{upperLimit}} + p_{\text{lowerLimit}} \quad (16)$$

This is the hitting probability of one volatility assumption. The *final* hitting probability is the weighted *mean* of all volatility assumptions, following the scheme discussed in section 3.5.

Since we have hitting probability values for different volatility scenarios, we can also compute the sensitivity of the hitting probability (and thus the option premium) against changes in the volatility. In the option pricing literature, this is sometimes called the “vega” of an option.

### 5 Final Pricing

The theoretical price (premium) of a box option is the product of the hitting probability  $p$  and the amount  $A$  of money paid when hitting the box.

In a preferred embodiment, a box option is sold at a slightly higher price than the theoretical price, in order to cover some risk and operating costs and to ensure that at least a minimum of profitability is attained.

In one preferred embodiment, we replace  $p$  by a modified probability  $p'$  with a safety margin, but still between 0 and 1:

$$p' = \frac{(1+c)p}{1+c}$$

where  $c$  is a non-negative safety parameter. A value  $c = 0$  leaves the probability unchanged, whereas a value  $c = 1$  implies a robust margin: a probability  $p = 1/2$  is modified to  $p' = 2/3$ .

In a second preferred embodiment, a small fee  $F$  per deal is charged. This fee should cover an operator of a preferred system’s in-house costs per individual deal (which are small but larger than zero) and prevent customers from buying too-small option contracts.

The option premium  $P$  is then

$$P = \frac{(1+c)p}{1+c} A + F \quad (17)$$



An initial value of  $c$  may be 1. However, option trading operators of a preferred system should have an on-line access to this variable. By carefully choosing and resetting  $c$ , system operators can control the optimal balance of risk, return, and trading volume.

## 6 Hedging the risk

Option traders often do not want to be exposed to the full risk of an option portfolio. Delta hedging is a usual way to reduce the risk: taking a position in the underlying instrument that neutralizes the risk due to sudden changes of the spot price.

The direct method (as well as the binomial or trinomial tree method) provides a numerical method to compute the delta (the first derivative of the option premium against the underlying spot price). Even if delta can be continuously computed, efficient delta hedging is an art when considering also the transaction costs and the re-hedging frequency which also depends on gamma, the second derivative.

The first question is whether delta hedging makes any sense for the box option of a preferred embodiment. The answer is yes, if the box asymmetrically extends to a region outside the neighborhood of the current spot price. Then the dynamic behavior of the box option is similar to that of a conventional option.

However, if the box is located around the level of the current spot price, delta hedging is not particularly relevant to the true risk. The value of such a box option is rather insensitive against the spot price, leading to delta values around zero. The main risk of such options arises from the behavior of volatility and its forecast. A similar problem exists in the opposite case, when all boxes are far away from the current spot price (but both below and above). The risk is similar to that of a straddle, strangle, or barrier option. A high quality volatility forecast reduces but does not totally eliminate this risk.

Thus, part of the risk of box options can be hedged through delta hedging, whereas another part cannot (or only through much more sophisticated methods).

There are two other ways to limit the risk: diversification and pricing margin. Diversification is the natural result of a large, heterogeneous group of customers, but hard to reach initially. The pricing margin has been discussed in section 5; choosing a sufficiently high  $c$  value will help to keep the risk at bay even in difficult situations.

## 7 The Algorithm

In this section, the recipe for pricing the option is given, step by step. The described method is designed for speed of computation.

The described method can be used in two ways:

1. as a piece of production software used to price box options in real time;
2. in a test program to explore the behavior of the box option with historical data.

The main piece of software presented in this section is preferably used in both applications.

The description of the software algorithm connects the theory described in the preceding sections with the software implementation of a preferred embodiment. It can be used both as a recipe for the software developer and as an implementation description for the theoretician.

### 7.1 Step 1: Configuration

There are a few constant configuration parameters of the algorithm that do not depend on the input parameters of a particular box option:

- The minimum time  $\Delta t_s$  from “now” to the start of the box option. The decision process of customers selecting a box option and confirming their option purchase may take a few seconds that allow them to watch the market, perhaps using quicker market price information than a preferred system’s official spot price. In order to prevent bad deals due to information advantages on the order of seconds, a minimum interval from “now” to the box option start-time of, say,  $\Delta t_s = 10$  minutes is specified.
- The maximum time  $\Delta t_e$  from “now” to the end time of the box option. We need this to limit the problem of interest rate differentials (see section 3.7).
- The assumed standard forecast error  $\sigma_\sigma$  of the logarithm of the volatility forecast. In a preferred embodiment, this is a constant configuration parameter:  $\sigma_\sigma = 0.2$  or thereabouts.
- The parameters of numerical integration (Hermite, Gaussian). These are mentioned below, in the steps where they are actually used.

- The safety margin parameter  $c$  of the pricing (see eq. 17). The initially chosen value is  $c = 1$  or slightly less .
- The maximum size  $A_{\max}$  of the option contract: the amount paid to the successful buyer of one box option is limited to  $A_{\max}$ . The size depends on the trading policy of an operator of a preferred system. Initially,  $A_{\max}$  may be something like 10,000 USD (U.S. dollars); in a mature system, it can be higher.
- The fee  $F$  per option contract. This is designed to cover the marginal costs of managing one additional contract and to prevent customers from buying options of too-small contract size.  $F$  may be small: something like 2 USD.

Note that the configuration parameter values are not engraved in marble. An operator of the preferred option trading system has the ability to change some values on-line (or at least through a quick re-start with no down-time visible to customers). The parameters that may be modified are  $\Delta t_s$ ,  $\Delta t_e$ ,  $c$ ,  $F$ ,  $A_{\max}$ , and  $\sigma_\sigma$ .

## 7.2 Step 2: Input data

The following input data is given at start of the box option pricing:

- The time “now”:  $t_{\text{now}}$ . This is the time point at which the pricing is computed. In real-time operation, this simply means reading the clock.
- The price “now”:  $p_{\text{now}}$ . This is the last valid, official spot price before or at  $t_{\text{now}}$ . We take the geometric mean of bid and ask price:  $p_{\text{now}} = \sqrt{p_{\text{bid}} p_{\text{ask}}} = \exp[0.5(\ln p_{\text{bid}} + \ln p_{\text{ask}})]$ .
- The time stamps of the box:  $t_s$  at start and  $t_e$  at the end of the box. These must obey the condition  $t_{\text{now}} + \Delta t_s \leq t_s \leq t_e \leq t_{\text{now}} + \Delta t_e$  .
- The lower and upper price limits of the box:  $p_a$  and  $p_b$ . These must obey the condition  $0 < p_a \leq p_b$ .
- A positive volatility forecast  $\sigma_0$ . In a preferred embodiment, there is only one such forecast: typically a forecast for one working day, starting at  $t_{\text{now}}$ . We need  $\sigma_0$  normalized to 1 day (not annualized or normalized to 1 working day), because it is used together with  $\vartheta$ -time, which is in units of days. (If the raw value is annualized, divide it by  $\sqrt{365.25}$ ).

- The size  $A$  of the payout that the user will receive if the price curve hits the box. To limit the risk to operators of the preferred system, a maximum value has to be observed:  $A \leq A_{\max}$ .

The software is preferably modular, so that a user of the box option pricing method does not have to care about the source of this input data. The existence of the input data is taken for granted herein.

### 7.3 Step 3: Convenient variables computed from the input data

We construct some convenient intermediary variables:

- Introduction of  $\vartheta$ -time. We compute the  $\vartheta$ -time increments between the time stamps:

$$\vartheta_s = \vartheta\text{Interval}(t_s, t_{\text{now}}) , \quad \Delta\vartheta = \vartheta\text{Interval}(t_e, t_s) .$$

For numerical reasons, we need  $\Delta\vartheta > 0$ . If  $\Delta\vartheta < 0.0001\vartheta_s$ , we correct it to  $\Delta\vartheta = 0.0001\vartheta_s$ . (We assume  $\vartheta = 0$  at  $t_{\text{now}}$ ; the box starts at  $\vartheta = \vartheta_s$  and ends at  $\vartheta = \vartheta_s + \Delta\vartheta$ ;  $\vartheta$  is always handled in units of days).

$\vartheta\text{Interval}$  computes the time difference between two time points, where the difference is in days on the  $\vartheta$ - time scale. However, although the precision is higher (resulting in a competitive advantage in option pricing) when  $\vartheta$ -time is used, other choices of business time could be used. Examples are normal clock time omitting the two week-end days (and then multiplying the resulting time interval by 1.4, or even normal, unmodified clock time).

- Logarithmic prices. We define  $x = \ln(p/p_{\text{now}})$  and take micro-oscillations into account according to section 3.6 :

$$\Delta x_{\text{micro}} = 0.04 \frac{\Delta\vartheta}{\Delta\vartheta + 0.0006} \sigma_0 ,$$

following eq. 1. (The constants of this formula could be formally treated as configuration parameters, but this is of little importance given the small size of  $\Delta x_{\text{micro}}$ ).

The logarithmic prices are computed as follows:

$$x_a = \ln(p_a/p_{\text{now}}) - \Delta x_{\text{micro}} , \quad x_b = \ln(p_b/p_{\text{now}}) + \Delta x_{\text{micro}} .$$

(This implies that the  $x$  value at  $\vartheta = 0$  is  $x(0) = 0$ ).

- Mean logarithmic volatility. The volatility  $\sigma_0$  is the assumed mean volatility. The mean *logarithmic* volatility is computed as follows:

$$\mu_\sigma = \ln \sigma_0 - 0.5\sigma_\sigma^2 .$$

We also use the variable  $\sigma'_\sigma = \sqrt{2}\sigma_\sigma$ .

#### 7.4 Step 4: Loop over different volatility scenarios

Now, we have to distinguish between different volatility scenarios and execute the following steps for each volatility scenario separately. The volatility  $\sigma_i$  of the  $i$ th scenario is computed with the following formula:

$$\sigma_i = \exp(\mu_\sigma + c_i \sigma'_\sigma) .$$

The factor  $c_i$  is a coefficient of Hermite integration (see Table 25.10 of (A & S 1970)). A preferred embodiment preferably uses  $n = 5$  is proposed. This means that we use 5 different volatility scenarios. In this case, the coefficients and the weights of Hermite integration are as follows:

$$c_1 = -2.02018 \ 28704 \ 56086 , \ w_1 = 0.01 \ 99532 \ 42059 \ 05 ;$$

$$c_2 = -0.95857 \ 24646 \ 13819 . \ w_2 = 0.3 \ 93619 \ 32315 \ 22 ;$$

$$c_3 = \ 0.00000 \ 00000 \ 00000 , \ w_3 = 0.9 \ 45308 \ 72048 \ 29 ;$$

$$c_4 = \ 0.95857 \ 24646 \ 13819 , \ w_4 = 0.3 \ 93619 \ 32315 \ 22 ;$$

$$c_5 = \ 2.02018 \ 28704 \ 56086 , \ w_5 = 0.01 \ 99532 \ 42059 \ 05 .$$

These values can be found in (A & S 1970), Table 25.10, Abscissas and Weight Factors for Hermite Integration. The weights  $w_i$  are needed at the end, when the final result is computed from all the different volatility scenarios. We store these constant weights in normalized form: we store normalized weights  $w'_i$  instead of the initial weights  $w_i$ . The formula to compute all  $w'_i$  is:  $w'_i = w_i/\sqrt{\pi}$ . The normalized weights  $w'_i$  add up to 1.

The next main step (described in section 7.5) is done for each volatility scenario separately.

#### 7.5 Step 5: Compute the box hitting probability

Here we are inside a volatility scenario with volatility  $\sigma_i$ . The computation of the box hitting probability, a central portion of the described method, is divided into the following sub-steps.

##### 7.5.1 Step 5a: Probability of hitting through the front

First we compute the probability of hitting the box through the front, using eq. 2:

$$p_{\text{front}} = 0.5 \left[ \Phi \left( \frac{x_b}{\sigma_i \sqrt{\vartheta_s}} \right) - \Phi \left( \frac{x_a}{\sigma_i \sqrt{\vartheta_s}} \right) \right]$$

The function  $\Phi(u)$  can be computed as `erf`( $\sqrt{2}u$ ), where `erf` is a function of the `math.c` library. As is known in the art, constants such as  $\sqrt{2}$  and repeatedly-used intermediary results such as the product  $\sigma_i \sqrt{\vartheta_s}$  should be stored and re-used instead of computed from scratch at each new application.

### 7.5.2 Step 5b: Probability of hitting through the upper limit

Computing  $p_{\text{upperLimit}}$  and  $p_{\text{lowerLimit}}$  requires a much larger effort. We start with  $p_{\text{upperLimit}}$ .

The integrand of eq. 5 has its highest value around a mean  $\mu'$  that results from eq. 10:

$$\mu' = \frac{\vartheta_s (x_b - \sigma_i \sqrt{\Delta \vartheta})}{\vartheta_s + \Delta \vartheta}$$

The variance of the integrand about this mean is approximately given by eq. 11:

$$\sigma'^2 = \sigma_i^2 \frac{\vartheta_s \Delta \vartheta}{\vartheta_s + \Delta \vartheta}$$

For  $\sigma_i$ , we insert the volatility of the selected volatility scenario.

Now, we make a numerical integration in a loop over different  $\xi$  values as follows. The integration limits are  $\xi_b$  and 1; we compute

$$\xi_b = \frac{x_b - \mu'}{\sqrt{4 \sigma'^2 + (x_b - \mu')^2}}$$

following eq. 12. We also need the middle of the  $\xi$  range,  $\xi_0 = 0.5(\xi_b + 1)$  and the size of the half range,  $\Delta \xi = 0.5(1 - \xi_b)$ .

The  $\xi$  values of the Gaussian integration are given by:  $\xi_j = \xi_0 + k_j \Delta \xi$ . The factor  $k_j$  is a coefficient of the Gaussian integration (see Table 25.4 of (A & S 1970)). In a preferred embodiment, we assume  $m = 6$  different function evaluations for the integration. This is a low number for numerical integration, leading to short computation time; the low number can be justified by the careful choice of the integration scheme. A higher number  $m$  leads to more precise results, of course. The coefficients and the weights of Gaussian

integration are as follows:

$$c_1 = -0.93246 \ 95142 \ 03152 \ , \ w_1 = 0.17132 \ 44923 \ 79170 \ ;$$

$$c_2 = -0.66120 \ 93864 \ 66265 \ , \ w_2 = 0.36076 \ 15730 \ 48139 \ ;$$

$$c_3 = -0.23861 \ 91860 \ 83197 \ , \ w_3 = 0.47862 \ 86704 \ 99366 \ ;$$

$$5 \quad c_4 = \ 0.23861 \ 91860 \ 83197 \ , \ w_4 = 0.47862 \ 86704 \ 99366 \ ;$$

$$c_5 = \ 0.66120 \ 93864 \ 66265 \ , \ w_5 = 0.36076 \ 15730 \ 48139 \ ;$$

$$c_6 = \ 0.93246 \ 95142 \ 03152 \ , \ w_6 = 0.17132 \ 44923 \ 79170 \ .$$

These values can be found in (A & S 1970), Table 25.4. The constant weights  $w_i$  are preferably stored in normalized form; that is, normalized weights  $w'_i$  are stored instead of the initial weights  $w_i$ . The formula to compute all  $w'_i$  is  $w'_i = 0.5w_i$  .

The normalized weights  $w'_i$  add up to 1.

The integration is a loop over all  $j$  from 1 to  $m$ . For each  $j$ , we compute  $\xi_j$  and then the corresponding logarithmic price  $x_j$ :

$$x_j = \mu' + \frac{2 \sigma' \xi_j}{\sqrt{1 - \xi_j^2}}$$

15 following eq. 13. Then the integrand is computed:

$$I_j = e^{-\frac{x_j^2}{2\sigma_i^2\vartheta_s}} \left[ 1 - \Phi\left(\frac{x_j - x_b}{\sigma_i\sqrt{\Delta\vartheta}}\right) \right] (1 - \xi_j^2)^{-1.5}$$

following eqs. 5 and 15. The function  $\Phi(\cdot)$  is computed as explained in section 7.5.1. The integral is a weighted sum using the normalized weights  $w'_j$  of Gaussian integration:

$$I = \sum_{j=1}^m w'_j I_j$$

20 This integral  $I$  has to be multiplied with the factors of eqs. 5 and 15:

$$p_{\text{upperLimit}} = \frac{2\sigma'}{\sqrt{2\pi}} \frac{I}{\sigma_i\sqrt{\vartheta_s}}$$

This is the desired probability  $p_{\text{upperLimit}}$ .

### 7.5.3 Step 5c: Probability of hitting through the lower limit

25 Computing  $p_{\text{lowerLimit}}$  is analogous to computing  $p_{\text{upperLimit}}$ , so the code to compute both variables can be shared to a high degree. In the following description, a full account

of the computation of  $p_{\text{lowerLimit}}$  is given. A software developer skilled in the art will find opportunities to use equivalent methods for computing  $p_{\text{lowerLimit}}$  and  $p_{\text{upperLimit}}$ .

The integrand of eq. 6 has its highest value around a mean  $\mu'$  (see eq. 10):

$$\mu' = \frac{\vartheta_s (x_a + \sigma_i \sqrt{\Delta\vartheta})}{\vartheta_s + \Delta\vartheta}$$

5 The model variance of the integrand about this mean is:

$$\sigma'^2 = \sigma_i^2 \frac{\vartheta_s \Delta\vartheta}{\vartheta_s + \Delta\vartheta}$$

(see eq. 11), just as for  $p_{\text{upperLimit}}$ . For  $\sigma_i$ , we again insert the volatility of the selected volatility scenario.

10 We again make a numerical integration in a loop over different  $\xi$  values. The integration limits are now  $-1$  and  $\xi_a$ ; we compute

$$\xi_a = \frac{x_a - \mu'}{\sqrt{4 \sigma'^2 + (x_a - \mu')^2}}$$

again following eq. 12. The middle of the  $\xi$  range is  $\xi_0 = 0.5(\xi_a - 1)$ , and the size of the half range is  $\Delta\xi = 0.5(1 + \xi_a)$ .

15 The  $\xi$  values of the Gaussian integration are given by:  $\xi_j = \xi_0 + k_j \Delta\xi$ . The factors  $k_j$  are again coefficients of the Gaussian integration; we take the same coefficients  $k_j$  and normalized weights  $w'_j$  as in section 7.5.2.

The integration is a loop over all  $j$  from 1 to  $m$ . For each  $j$ , we again compute  $\xi_j$  and then the corresponding logarithmic price  $x_j$ :

$$x_j = \mu' + \frac{2 \sigma' \xi_j}{\sqrt{1 - \xi_j^2}}$$

20 (following eq. 13). Then the integrand is computed:

$$I_j = e^{-\frac{x_j^2}{2\sigma_i^2\vartheta_s}} \left[ 1 - \Phi\left(\frac{x_a - x_j}{\sigma_i \sqrt{\Delta\vartheta}}\right) \right] (1 - \xi_j^2)^{-1.5}$$

(see eqs. 5 and 15). The function  $\Phi(\cdot)$  is again computed as explained in section 7.5.1. The integral is a weighted sum using the weights  $w'_j$  of Gaussian integration:

$$I = \sum_{j=1}^m w'_j I_j$$



This integral  $I$  has to be multiplied by certain factors, as in section 7.5.2:

$$p_{\text{lowerLimit}} = \frac{2\sigma'}{\sqrt{2\pi}} \frac{I}{\sigma_i \sqrt{\vartheta_s}}$$

This is the desired probability  $p_{\text{lowerLimit}}$ .

#### 7.5.4 Step 5d: Probability of hitting the box anywhere

5 The total box hitting probability is given by eq. 16:

$$p_i = p_{\text{front}} + p_{\text{upperLimit}} + p_{\text{lowerLimit}}$$

We write  $p_i$  because this result still belongs to the  $i$ th volatility scenario. In some very extreme cases, a  $p_i$  value of slightly more than 1 may result – an impossible value for a probability. In that case, it must be corrected down to  $p_i = 1$ .

#### 10 7.6 Step 6: Joint box hitting probability of all scenarios

The different volatility scenarios are now brought together, thus terminating the loop started in section 7.4.

The resulting box hitting probability is a weighted sum

$$p = \sum_{i=1}^m w'_i p_i$$

15 The normalized weights  $w'_i$  of Hermite integration as defined in section 7.4 have to be taken. This is the final box hitting probability.

In an alternate embodiment, we also compute a side result: the sensitivity of  $p$  (and thus the option premium) against changes (also: bad forecasts) of volatility. When using the scheme of section 7.4 with 5 volatility scenarios, the following approximative

20 formula applies:

$$\partial p / \partial \sigma = (p_4 - p_2) / (\sigma_4 - \sigma_2)$$

(for  $\sigma_i$ , see section 7.4). This is closely related to the “vega” of the box option.

In a further embodiment, the computation of delta for delta hedging is also performed. This requires another full computation of a hitting probability, so it essentially

25 doubles the computation time. (For also computing the gamma of the box option, we even need a third computation).

#### 7.7 Step 7: Computing the final price

The option premium  $P$  is computed from the hitting probability  $p$  according to eq. 17:

$$P = \frac{(1+c)p}{1+cp} A + F$$

This may be rounded up to the next higher integer USD amount (which means an additional fee of few cents). In some extreme cases, the price  $P$  may slightly exceed  $A$  by few USD. Such a contract would make no commercial sense, since the premium exceeds the payout.

The price  $P$  is the final result of our box option pricing. A system operator preferably offers the box option contract based on a potential payout  $A$  at a premium  $P$ .

## 8 Solutions based on binomial or trinomial trees

In section 4, we saw that we do not need binomial or trinomial trees to price the box option. However, such a tree-based solution is suitable for differently shaped target areas (e.g., circles or triangles), for which an analytical or easily integrable solution does not exist.

Binomial trees imply a discretization error: the target zone, (e.g., the box), is approximated by a finite set of nodes of the tree (see **FIG. 2**). This error can be large for boxes comparable to or smaller than the elementary cells of the binomial tree. In that case, standard correction methods are typically necessary to limit the size of the error.

The binomial tree (see **FIG. 3**) is known in the art, and has been introduced to derive option prices through arbitrage arguments. On the other hand, it also provides an approximation of *probabilities* associated to price paths and price target ranges. This is the relevant fact for pricing the box option, since the premium is essentially the box-hitting probability times the pay-off sum.

A binomial tree approximates a Gaussian random walk or Brownian motion (log-normal if this process applies to logarithms of spot prices). It is known that the Brownian motion leads to a normal distribution that grossly underestimates the true probability of extreme price changes (and thus the true probability of hitting a box located at extreme prices). This is a particularly important problem for short-term, intra-day time intervals.

This problem of heavy tails has already been discussed in section 3.5. We solve it as proposed there: assuming different binomial trees based on different volatility assumptions

and averaging the resulting hitting probabilities. The method is then very similar to the main method described above, except that individual hitting probabilities are computed through ordinary binomial trees.

## 9 Functional Description

### 9.1 User's perspective

A preferred user application runs as a Java applet (e.g., based on Java AWT 1.1) from a conventional Web Browser (such as Netscape or Windows Explorer), running on a personal computer, such as a Pentium<sup>TM</sup>-based system, communicating with a Webserver via HTTP. To start the application, the user connects to the appropriate URL through a Web Browser. A registered user is prompted to enter a username and password through a form dialog. New (test) users do not need to enter any authorization information, but application functionality is restricted.

After successful connection, a display as depicted in **FIG. 1** appears. The display preferably features multiple charts, which are selected and viewed individually by clicking with a mouse (the term “mouse” is used herein to refer generically to any device that controls the movement of a cursor or pointer on a computer display screen; the terms “screen,” “computer screen,” and computer display screen” are all used herein to refer to any display device that is capable of graphically displaying data received from a computer) on “filing tabs” (EUR-USD, USD-CHF, EUR-CHF, etc.). A menu option allows the set of charts to be re-configured by the user, who can choose from a larger superset. Above the charts is a “Blotter” **135** for transactions and a “Bookkeeper” **140** for accounting information, also interchangeably selectable via filing tabs.

The charts display a time progression of sampled data, in the form of high/low limits and a mean average for each sampling period. A “Zoom” slider **110** allows the time axis scaling and corresponding sample interval size to be adjusted by the user, so that different time ranges - from approximately 1 day to a few months - can be viewed at will.

Data for each chart is fetched from the Webserver on first display. Thereafter, the charts are kept updated by a background thread running in the applet, continuously fetching updates from the Webserver on a periodic basis. Updates are displayed immediately to give a “pseudo-real-time” impression. The applet caches sampled data for the full extent of the zoom ranges so that zooming is fast and responsive - i.e., zooming does

not require different data to be fetched from the Webserver.

A “Viewpoint” slider **115** allows a user to move the position of the latest chart point to either the right or left side of the chart. By moving it to the left, more history data becomes visible. By moving it to the right, more “playing area” becomes available for placing windows, as described below.

The chart responds to interaction with a mouse. If the mouse is positioned in the “history” region (the area up to the last chart point), the sampled data values at that position are displayed above the chart in text form. If the mouse is clicked beyond (to the right of) the last chart point, the position is used as an anchor point for a new option box. By keeping the mouse pressed and dragging in any direction, the box dimensions can be “drawn” by the user. The new (dragged) mouse position is taken to mark the corner of the box that is diagonally opposite to the anchor point.

A box defines start-time  $t_s$  and end-time  $t_e = t_s + \Delta t$ , and lower price limit  $x_a$ , and upper price limit  $x_b$ . To assist the user, these limits are displayed as text as they size the box. For the time limits (start-time and end-time), the user is constrained by the available area between the latest chart point plus a threshold distance from that point and the right-hand graphical bound of the chart (this is the “playing area”). For the price limits, the user may drag the mouse above or below the graphical bounds of the chart, causing the y-axis (price axis) to be instantly re-scaled to provide a wider range of values.

Once a box has been created in the playing area, context-sensitive buttons below the chart become active. A “Price” button **120** causes the applet to request a price quote for the box from the Webserver. A “Cancel” button **125** causes the new box to be erased.

When the Price button is pressed, a popup dialog window appears in which a booking is formulated. The applet fetches a price quote from the Webserver, which is delivered in the form of a win ratio. The user is invited to select a stake and terms of transaction and is advised what the corresponding payout will be if the box wins. The interpretation of a win (when a payout is made) is as follows:

Buy or Sell	Hit or Miss	Payout	If . . .
Buy	Hit	To User	The chart plot enters the bounds of the box
Sell	Hit	By User	The chart plot enters the bounds of the box
Buy	Miss	To User	The chart plot does not enter the bounds of the box
Sell	Miss	By User	The chart plot does not enter the bounds of the box

The user adjusts the bounds of the box by editing the values shown in a popup dialog window **1900** (see **FIG. 19**); these adjustments are immediately reflected in the chart display depicted in **FIG. 1**. The user requests an updated price quote by clicking on an "Update" button **1925** in the dialog window **1900**.

Once the user has sized the box as desired (by inputting appropriate values into fields **1905**, **1910**, **1915**, and **1920**), input a "stake" in field **1935**, and found the displayed price quote ("Current payout level" **1945**) attractive, the user clicks a "Submit" button **1940** in the popup dialog which causes the box bounds to be submitted to the Webserver for booking. The actual payout associated with the box is determined at time of booking and not before. The popup dialog window **1900** therefore includes a field **1930** in which the user can specify a lower payout limit. If the payout determined at time of booking is less than the lower limit, the booking is rejected.

The Webserver returns the booking status, indicating whether the booking was accepted or if it failed for any reason. If the booking failed, the reason is reported in the popup dialog window. In this case, the user may make further adjustments to the box or booking terms and attempt to submit the booking again.

Once a transaction has been successfully booked the popup window becomes hidden. The box remains visible in the chart and is from thereon monitored by a backend server. An entry is displayed in the transaction Blotter and the accounting information seen in the Bookkeeper is updated. Test users are not able to book actual transactions – a message box **1950** notifies users when they are in test (demo) mode.

Once the backend server determines the box outcome (either when the chart plot enters the bounds of the box or when the time window elapses), it notifies the Webserver, which in turn delivers the status information to the client through the client's regular update mechanism. A "successful" box is displayed on the chart in green, an "unsuccessful" box in red, and the transaction blotter is updated accordingly.

In addition to the mouse functionality already described, a user can select an existing box by using the mouse to click on it in the chart or on the entry in the Blotter. Context-sensitive buttons below the chart become active, to support the following functionality:

5           For inactive boxes, the box can be erased from the chart.

For active boxes, a complementing transaction that cancels out the existence of the box can be requested. A popup dialog window appears in which the user is prompted to confirm the transaction.

10           By keeping the mouse button pressed and dragging the mouse, active boxes may be repositioned, or by clicking the mouse on an edge of an active box and dragging the mouse, the box may be resized. These hybrid transactions involve first canceling the previous box with a complementing transaction and then generating a new transaction for the new bounds. A popup dialog window appears in which the user is prompted to confirm the hybrid transaction after the relevant quotes have been fetched from the Webserver.

15           Menu options support settlement of an account balance, allowing the user to pay in or receive pay-out of credit. See **FIG. 13**.

## 9.2 Supporting Modules

20           **FIG. 7** illustrates the back-end modules for supporting the Box Option application as a Web service (“Chart-Win”, in a preferred embodiment). The term “CORBA” refers to architecture used in a preferred embodiment. “CORBA” is an acronym for Common Object Request Broker Architecture, which is an architecture that enables pieces of programs, called objects, to communicate with one another regardless of what programming language they were written in or what operating system they are running on.

The roles of the application servers are as follows:

### 25           9.2.1 Chart server

A preferred embodiment has one or more Chart servers **730**. Each Chart server **730** preferably has the following functionality: (a) one server (process) per chart; (b) primary recipient of realtime prices; (c) delivers sampled prices to clients (Webservers); (d) computes volatility from incoming prices; (e) computes price quotes on demand; (f)  
30           interacts with Bookkeeper **735** for option transactions (the term “window” is occasionally

used herein and in the figures as a synonym for “option”); (g) assesses outstanding options for hit or miss; and (h) notifies clients (e.g., Webservers) of option outcomes.

### 9.2.2 Bookkeeper

A Bookkeeper module **735** preferably has the following functionality: (a) single point of access to customer database; (b) notified of option transactions by Chart server; and (c) user account details checked and updated on transaction confirmation.

### 9.3 Module interaction

The underlying back-end mechanisms that operate to support the front-end GUI functionality, as well as user interaction with the front-end GUI functionality, are described below.

**FIGS. 14-18** illustrate steps of a preferred process for option creation and pricing. The description below comprises a description of interaction between modules for a user who has started a user application of a preferred embodiment and has a chart (see **FIG. 1**) in which the user desires to create an option. The option is accepted and tracked until its outcome.

Referring to **FIG. 14**, at step **1410** a Chart server **730** (see **FIG. 7**) receives price ticks from a price feed **740**. At step **1420** Chart server **730** sends sampled price data to subscribed clients, such clients including Webservers **715** that are subscribed to Chart server **730** for updates. This process is further illustrated in **FIG. 8**. At step **1430** a user application residing on a user (client) computer **710** sends an update request to a Webserver **715** via the Internet. At step **1440** Webserver **715** responds to the update request with update data, including the sampled price data received from Chart server **730**. At step **1450** the user application receives the update from Webserver **715** and displays the latest price data in the chart (see **FIG. 1**). This process is further illustrated in **FIG. 9**.

At step **1460** the user draws a box option **130** (see **FIG. 1**) with a mouse. At step **1470** the user application sends the option parameters to Webserver **715** via the Internet. At step **1480** Webserver **715** forwards the received option parameters to Chart server **730**. At step **1490** Chart server **730** uses the pricing algorithm described above in Section 7 to calculate a win ratio (ratio of option cost to potential payout). This process

is further illustrated in **FIG. 10**.

Referring to **FIG. 15**, at step **1500** Chart server **730** responds to Webserver **715** with a quote (comprising the calculated win ratio). At step **1520** Webserver **715** sends the received quote details to the user application via the Internet. At step **1530** the user application displays received quote information and invites the user to select transaction terms.

At step **1540** the user selects desired transaction terms, including the stake (option price), buy-or-sell, and hit-or-miss. At step **1550** the user application uses the received win ratio to calculate the corresponding payout for the selected transaction terms selected, and displays the payout information. At step **1560** the user confirms the selected transaction terms. At step **1570** , the user application sends the user's transaction request to Webserver **715** via the Internet. At step **1580** Webserver **715** sends the received transaction request to Chart server **730**.

Referring to **FIG. 16**, at step **1600** Chart server **730** checks that the box bounds are within acceptable limits. At step **1610** , if the box bounds are within acceptable limits, Chart server **730** calculates a new quote for the transaction. At step **1615**, Chart server **730** compares the computed payout with the minimum limit specified by the user. At step **1620** , if the payout is above the user's minimum level, Chart server **730** sends the received user transaction parameters to Bookkeeper **735** for confirmation. At step **1630** Bookkeeper **735** retrieves the user's account information. At step **1640** the Bookkeeper **735** examines the credit level of the user's account. At step **1660**, if the credit level for the user's account is satisfactory, Bookkeeper **735** books the transaction to the user's account.

At step **1660** Bookkeeper **735** responds to Chart server **730** with the transaction booking status. At step **1670**, if the transaction was successfully booked, Chart server **730** saves the option details into option database (window database) **725** and adds the option to the set of options for tracking. Steps **1570** through **1670** are further illustrated in **FIG. 11**.

At step **1680** Chart server **730** notifies Webserver **715** of the transaction booking status. At step **1700** (see **FIG. 17**), Webserver **715** sends the transaction booking status to the user application via the Internet. The user application then displays transaction parameters **155** (see **FIG. 1**) comprising Window (i.e., option), Chart (i.e., FX rate),



Status, Stake, Payout, etc.

Referring to **FIG. 17**, at step **1710** Chart server **730** receives price ticks from price feed **740**. At step **1720** Chart server **730** checks the option to see whether its outcome can be determined. At step **1730** the outcome of the option is determined by Chart server **730**. At step **1740** Chart server **730** updates option database **725** with the option outcome. At step **1750**, if a payout for the option is due, Chart server **730** sends the payout details to Bookkeeper **735**. At step **1760** the Bookkeeper **735** retrieves the user's account information, and at step **1770** the Bookkeeper updates the accounting records in account database **720**. At step **1780** Chart server **730** notifies Webserver **715** of the option outcome. Steps **1710** through **1780** are further illustrated in **FIG. 12**.

Referring to **FIG. 18**, at step **1810** the user application sends an update request to Webserver **715** via the Internet. At step **1820** Webserver **715** responds to the received update request by sending update data to the user application. The update data comprises option outcome information. At step **1830** the user application displays the option outcome. This process is further illustrated in **FIG. 9**.

Other embodiments are within the scope of the following claims. For example, the techniques described herein are not limited to any particular hardware or software configuration. They may be applied in any computing or processing environment that may be used for data storage, transmission, and display. Preferably, the techniques are implemented in computer programs executing on programmable computers that each include a processor, at least one input device, and at least one output device.

## Claims

What is claimed is:

1. A method of option creation, comprising the steps of:
  - (a) viewing on a computer screen connected to a computer a graphical display that shows the values of an asset over time;
  - (b) drawing a zone on the graphical display, wherein said zone is located in an area of the display that corresponds to future potential asset values, and wherein said zone represents a proposed option on the asset; and
  - (c) in response to a displayed win ratio, entering preferred settings for said option.
2. The method of claim 1, wherein said preferred settings comprise a desired price to be paid for said option.
3. The method of claim 1, wherein said preferred settings comprise a desired payout amount for said option.
4. The method of claim 1, wherein said zone is rectangular.
5. The method of claim 1, wherein said graphical display comprises a time-price curve.
6. The method of claim 1, wherein said asset is a currency.
7. A method of option creation and pricing, comprising the steps of:
  - (a) receiving data representing values of an asset over time;
  - (b) storing said data in a computer-readable medium;
  - (c) transmitting data representing the values of an asset over time to a remotely located computer;
  - (d) receiving from said remotely located computer values representing parameters of a proposed option on the asset;
  - (e) calculating a win ratio for the proposed option; and
  - (f) transmitting said win ratio to said remotely located computer.

8. The method of claim 7, wherein said proposed option is a box option.
9. The method of claim 8, wherein said parameters of a proposed option comprise a start time, an end time, an upper limit, and a lower limit.
10. Computer software for generating a graphical display of an option, comprising:
  - 5 (a) software for receiving and storing data representing values of an asset over time;
  - (b) software for displaying said values on a computer screen;
  - (c) software for drawing zones on said computer screen; and
  - (d) software for transmitting parameters of said zones.
11. The method of claim 10, further comprising software for receiving and displaying a  
10 win ratio.
12. The method of claim 11, further comprising software for using a win ratio to calculate and display an option price.
13. The method of claim 11, further comprising software for using a win ratio to calculate and display a payout amount.
14. The method of claim 10, wherein said zones are rectangular.  
15
15. A method of pricing box options, comprising the steps of:
  - (a) receiving data representing values of an asset over time;
  - (b) receiving data representing parameters of a box option on said asset;
  - (c) computing a probability of the value of the asset hitting the box from the front;
  - 20 (d) computing the probability of the value of the asset hitting the box from the top;
  - (e) computing the probability of the value of the asset hitting the box from the bottom;
  - (f) computing the probability of the value of the asset hitting the box anywhere;
  - 25 and

(g) computing a price for the option by multiplying a modified probability  $p'$  times an amount of money to be paid for hitting the box, then adding a transaction fee, wherein said modified probability  $p'$  is calculated according to the formula:

$$p' = \frac{(1+c)p}{1+c}$$

5 where  $c$  is a non-negative safety parameter and  $p$  is the probability of the value of the asset hitting the box anywhere.

16. The method of claim 15, wherein the probabilities of the value of the asset hitting the box from the front, top, and bottom are computed using a plurality of volatility scenarios.

10 17. The method of claim 16, wherein the probability of the value of the asset hitting the box from anywhere is computed according to the formula:

$$p = \sum_{i=1}^m w'_i p_i$$

where  $p_i$  is the probability of hitting the box anywhere for an  $i$ th volatility scenario, and  $w'_i$  is a normalized weight of Hermite integration.

15 18. The method of claim 15, wherein the transaction fee is zero.

## Abstract

A preferred embodiment of the subject invention is directed to creation and pricing of an option related to a target zone in a time-price plot. If the price curve against time enters this zone (in a preferred embodiment, a “box”), a fixed amount of money is paid to the owner of the option; if the curve misses the box, there is no payout to the option owner, who also forfeits the premium paid for the option. Software is described that enables an option buyer to easily create and set the parameters of such an option, that computes a premium for the option, and that manages payout and other functions related to the option. The above-described embodiment is a buy-to-hit option. Other embodiments are directed to sell-to-hit, buy-to-miss, and sell-to-miss options.

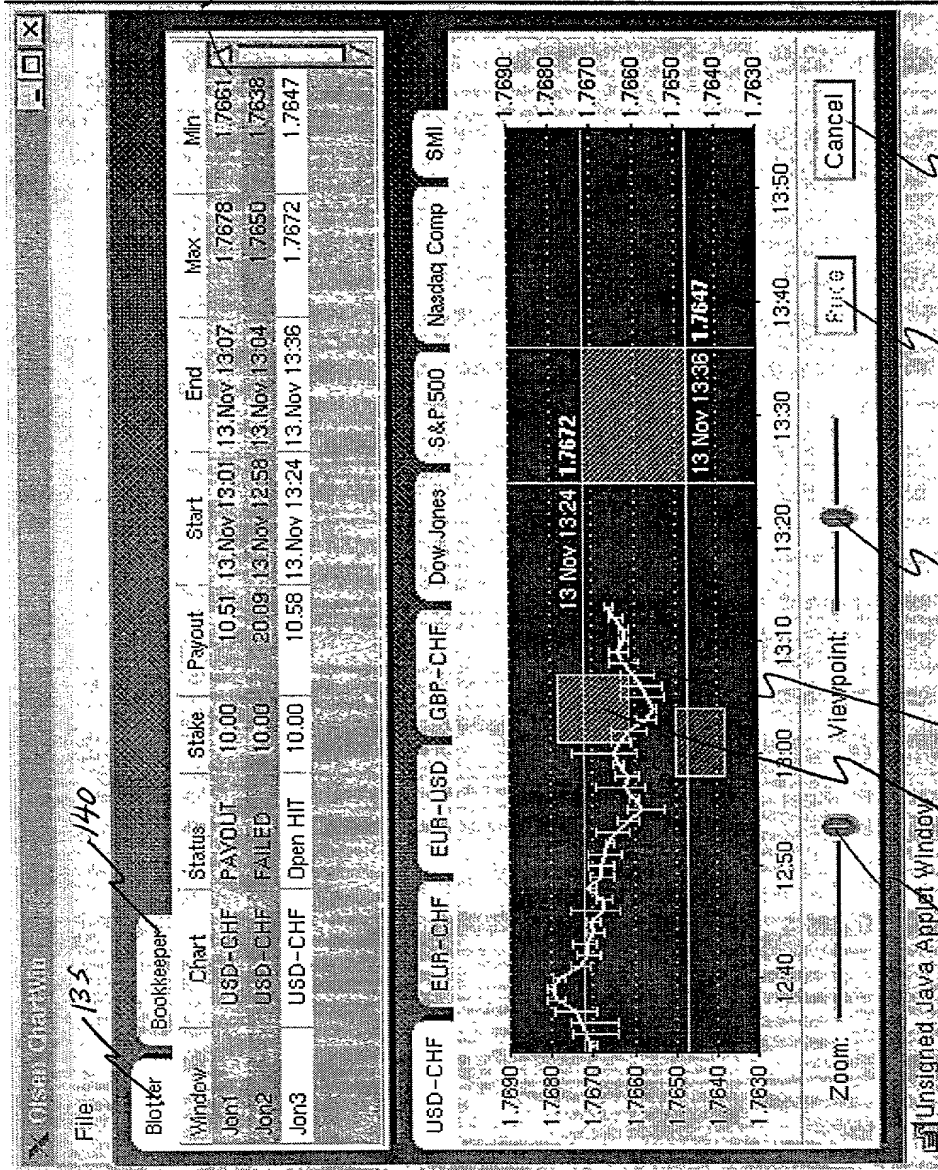


FIG. 1

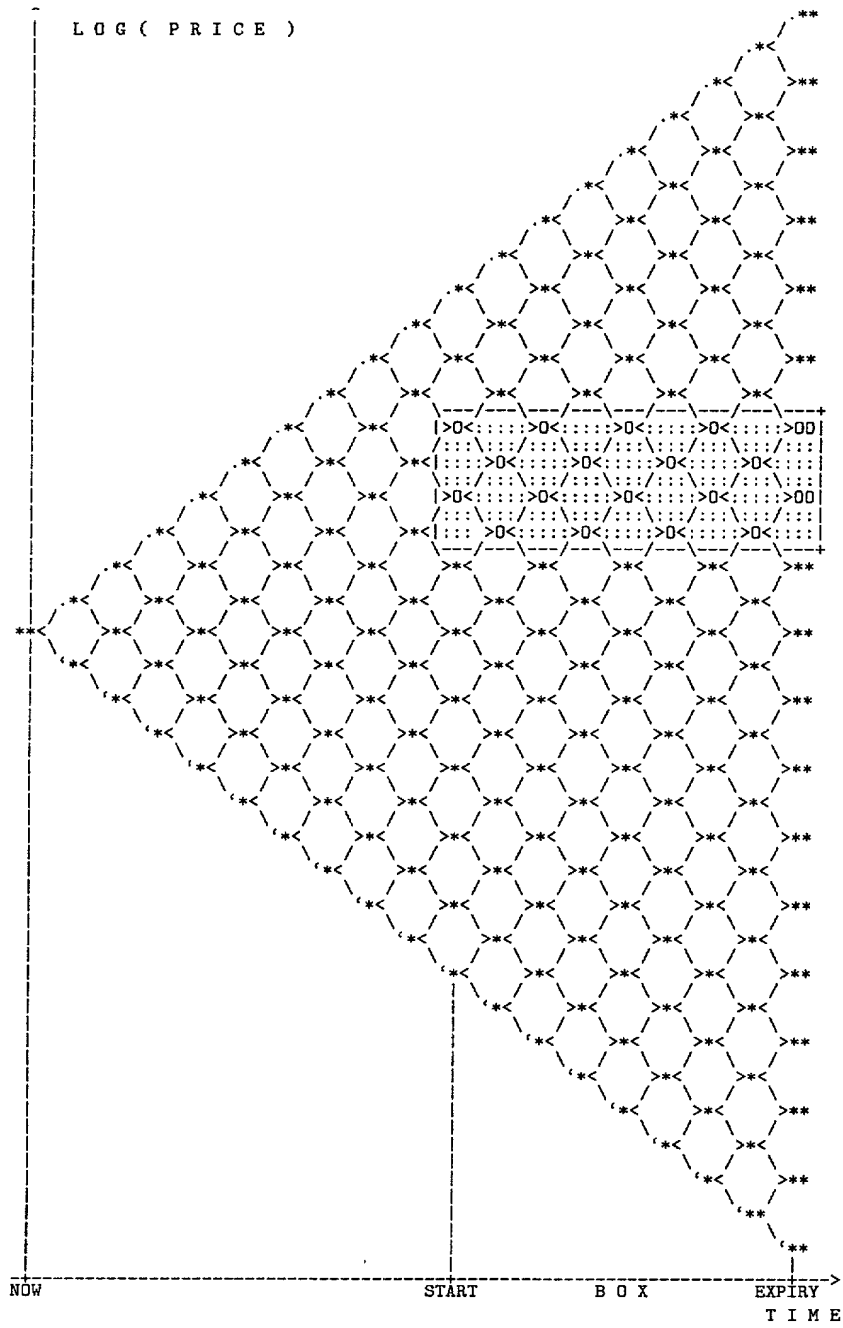


FIG. 2

$\log(\text{price})$

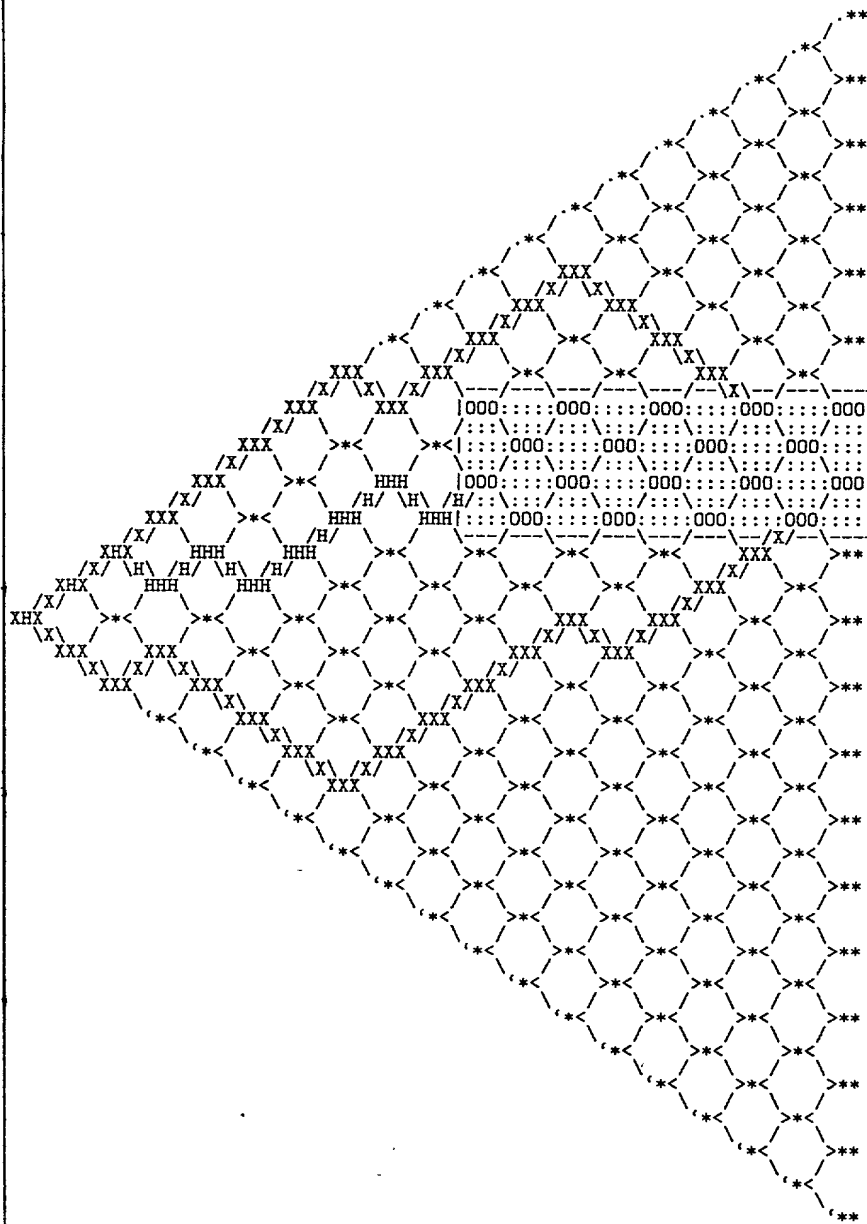
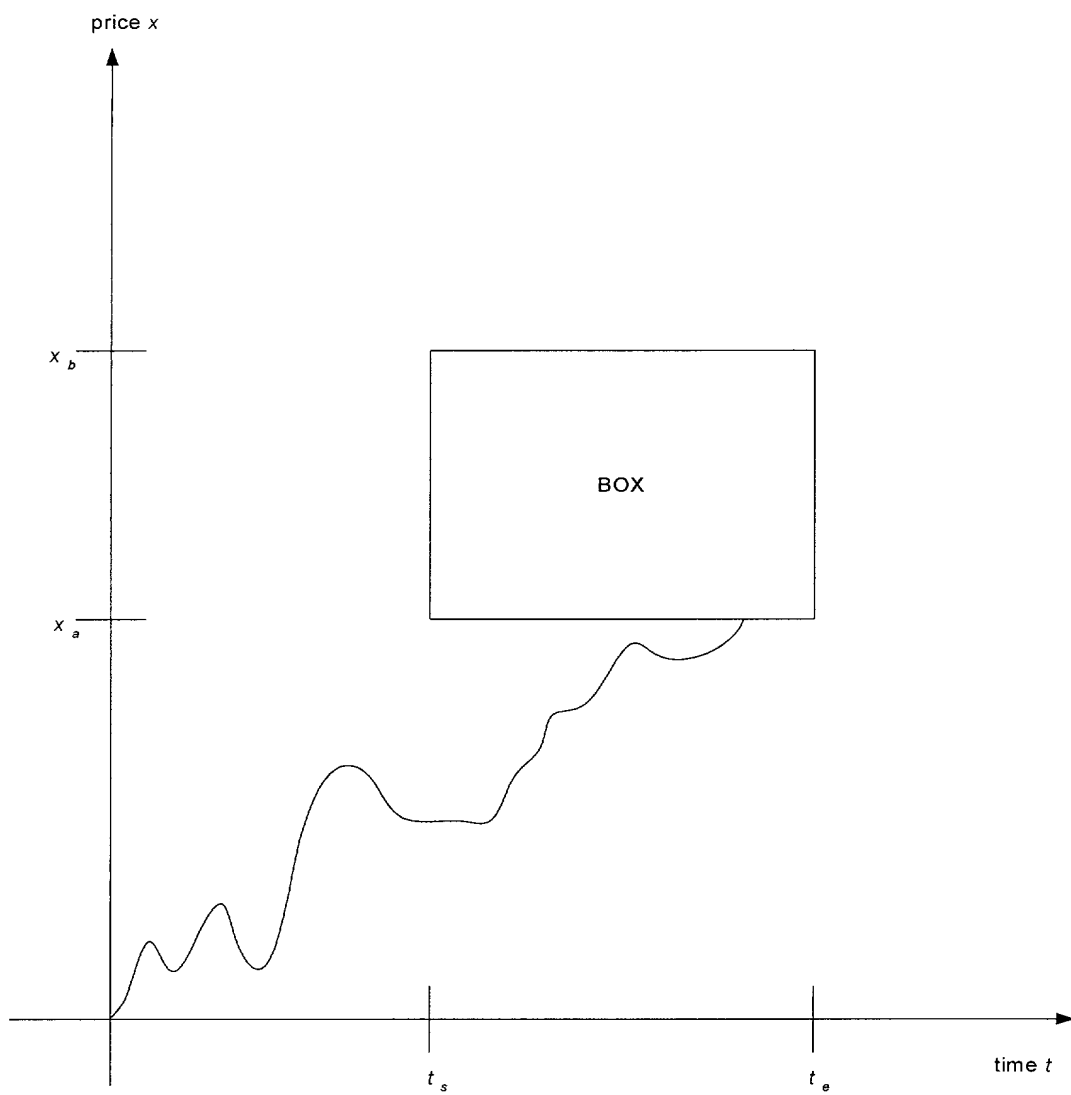


FIG. 3

*time*





**FIG. 4**

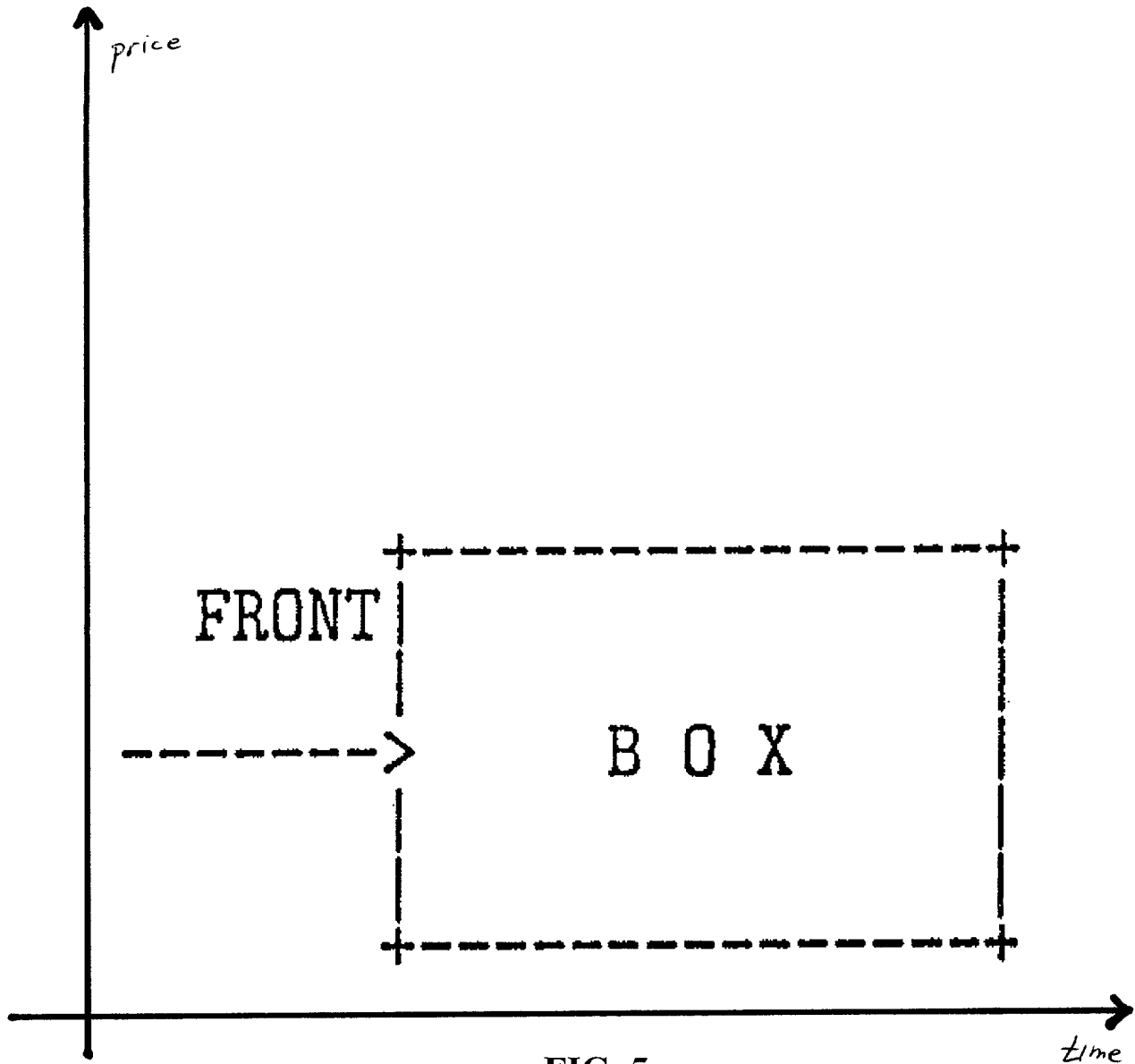


FIG. 5

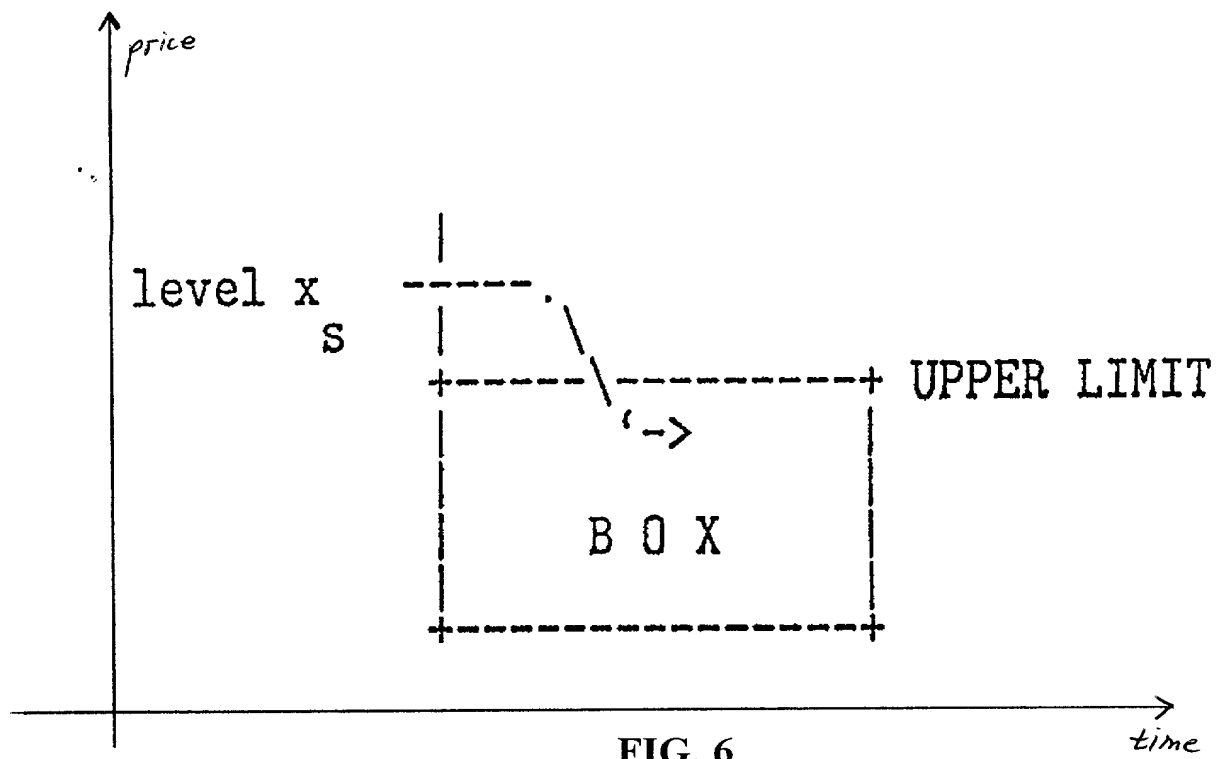


FIG. 6

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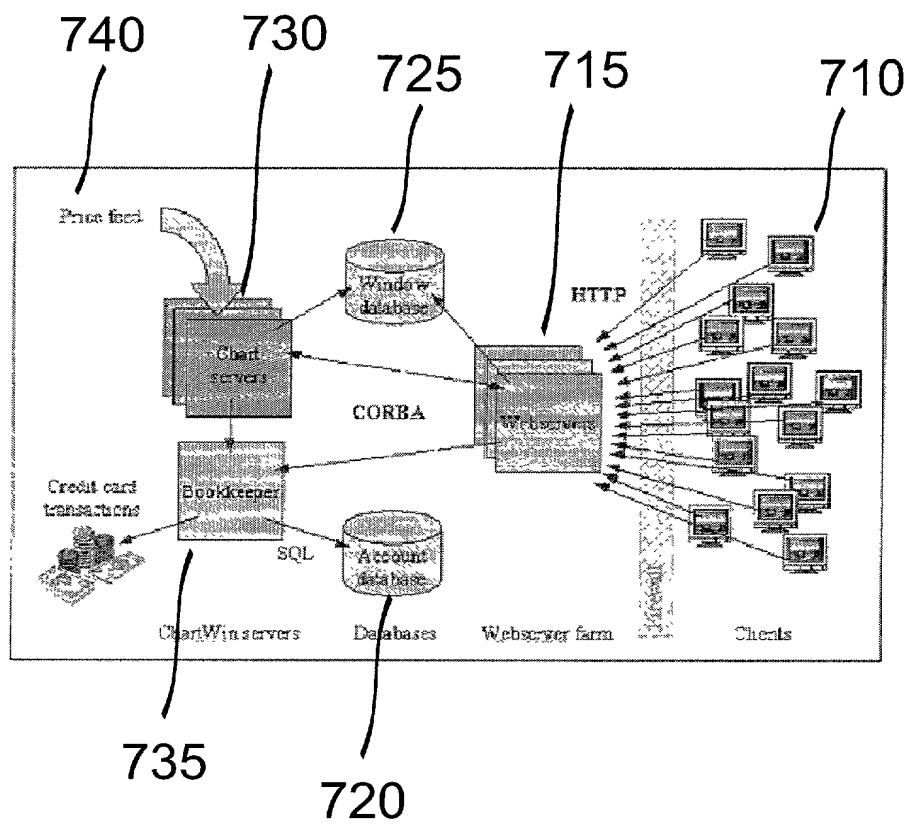
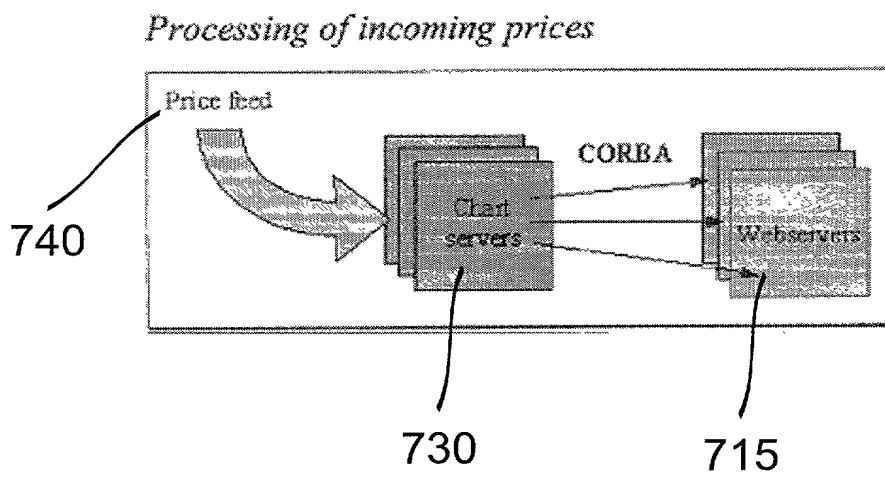
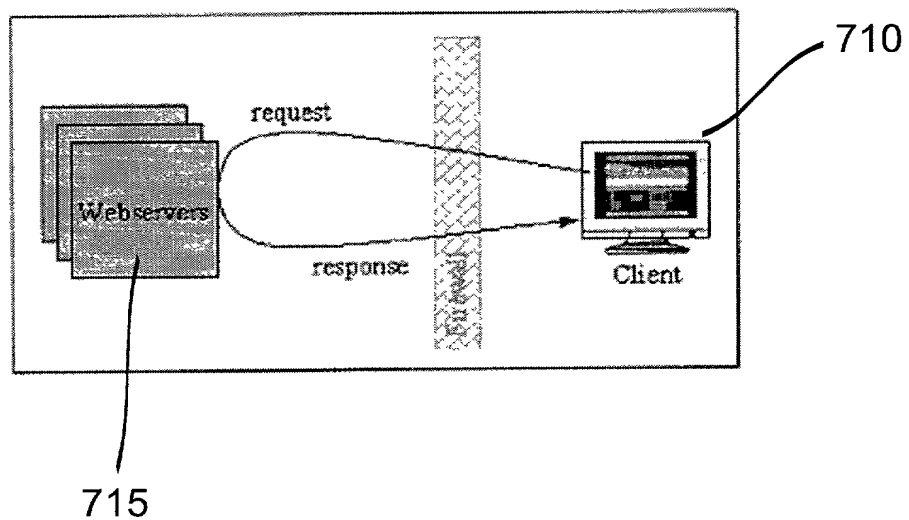


FIG. 7

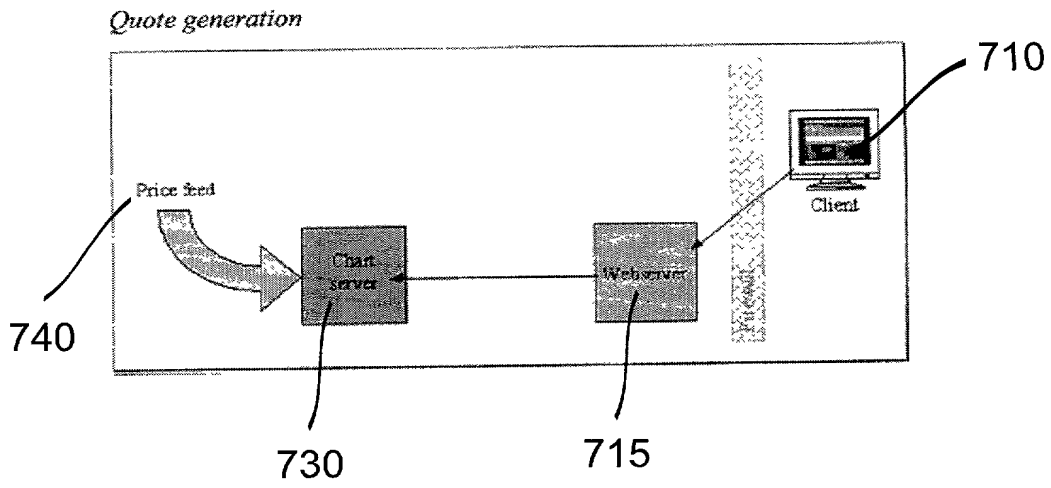


**FIG. 8**

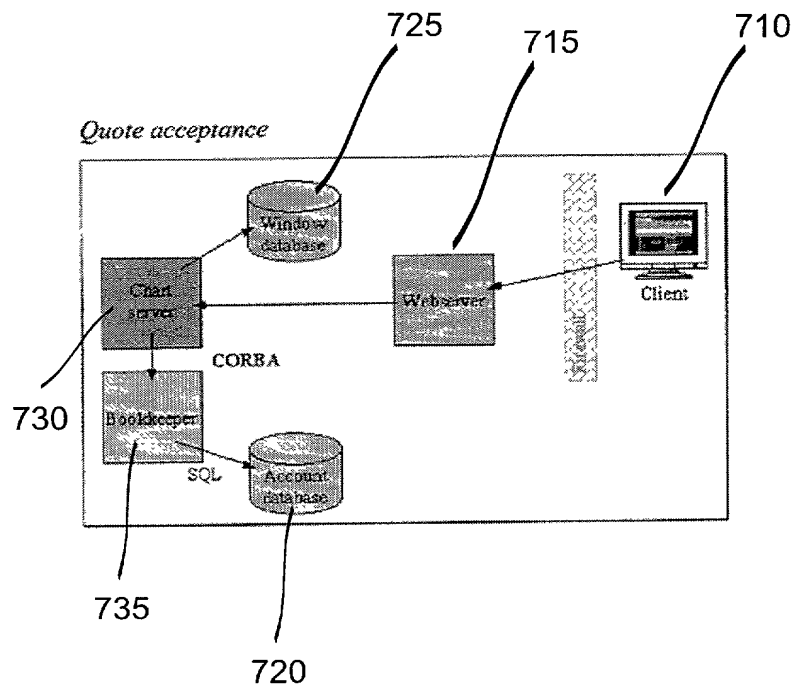
*Client updates*



**FIG. 9**

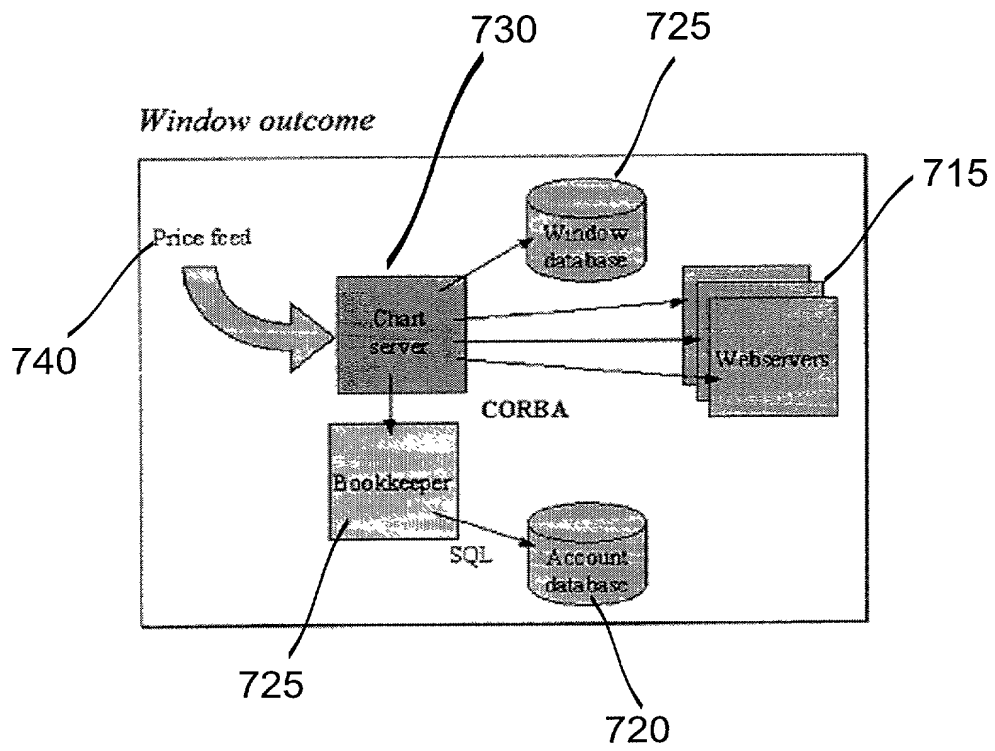


**FIG. 10**



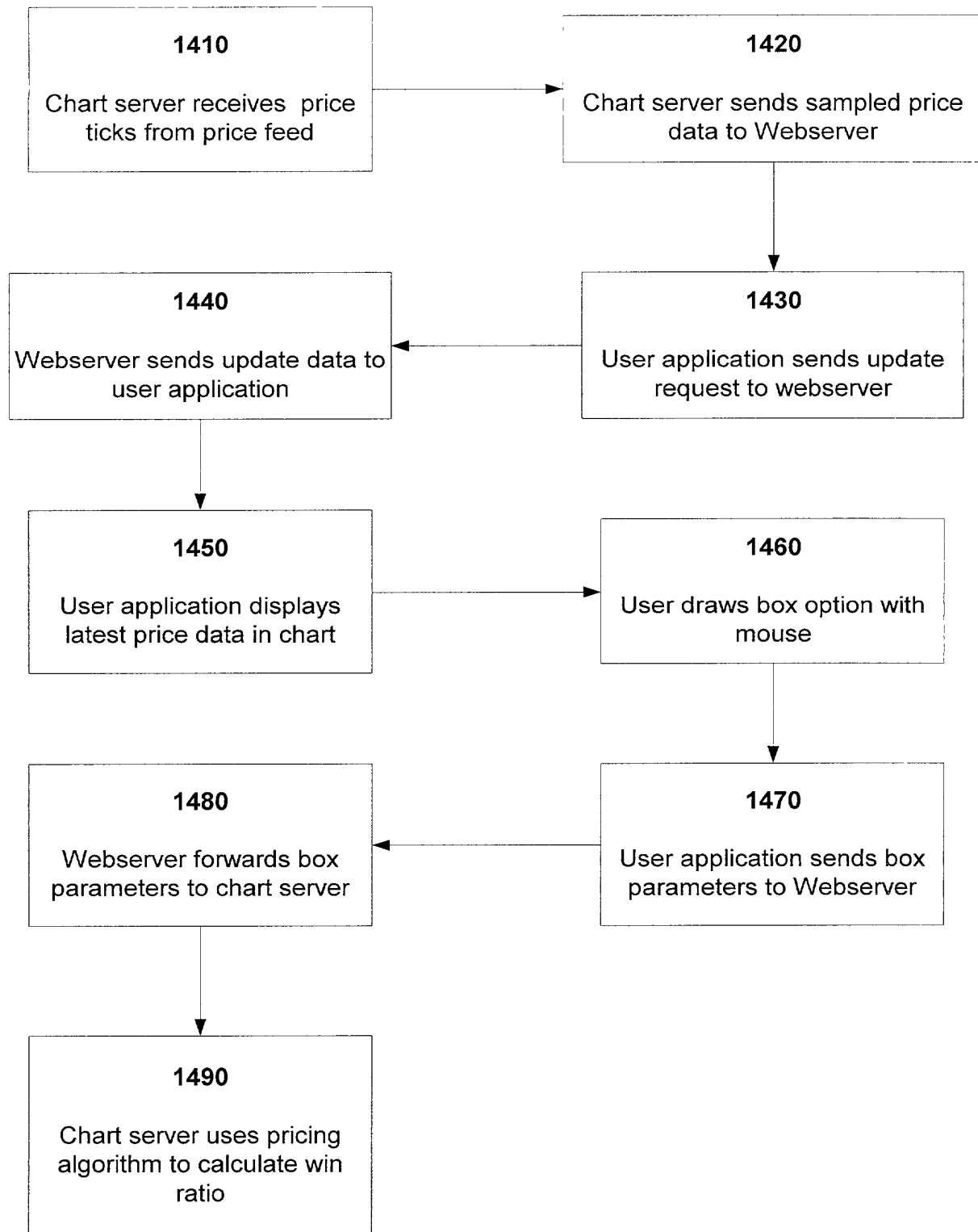
**FIG. 11**



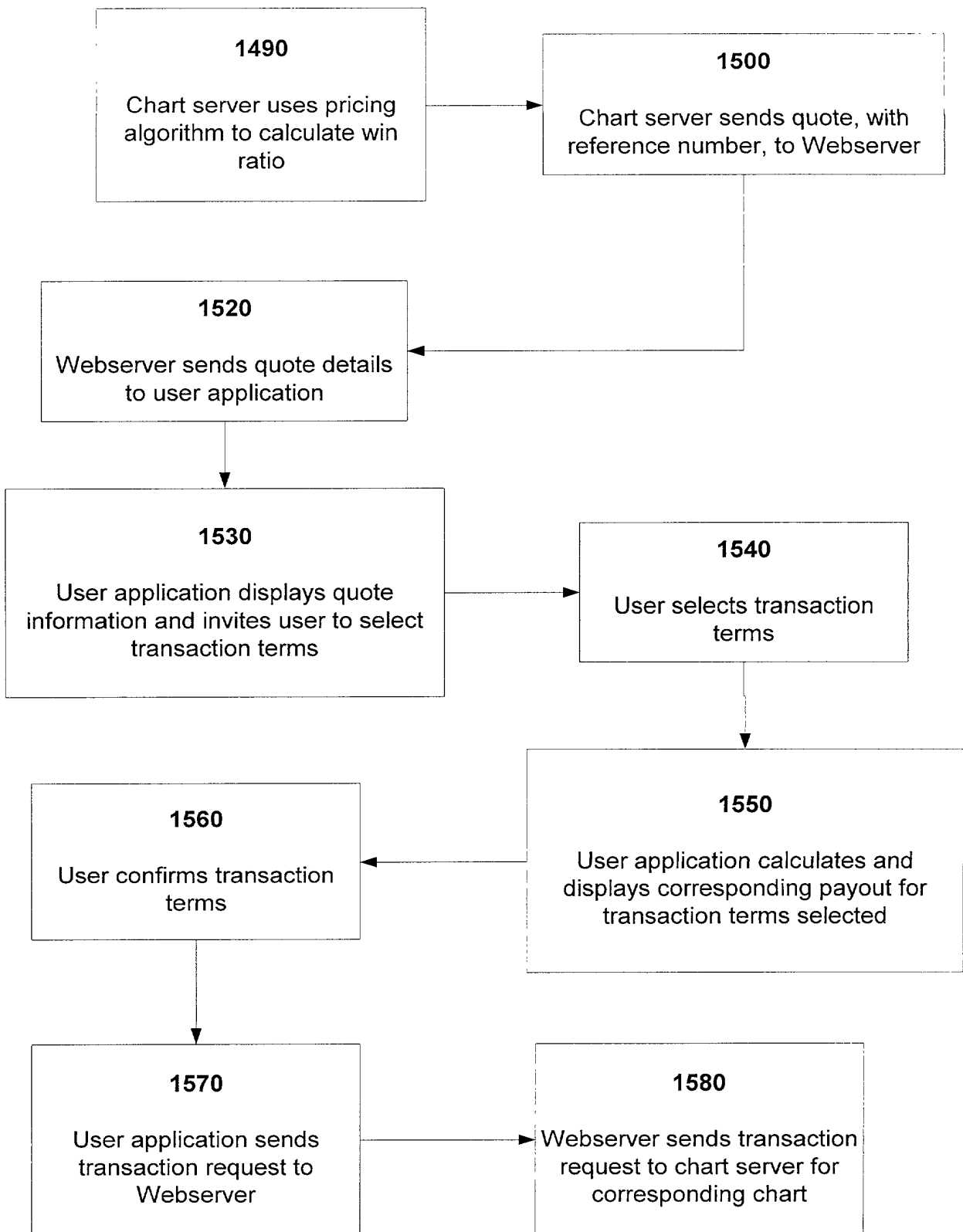


**FIG. 12**

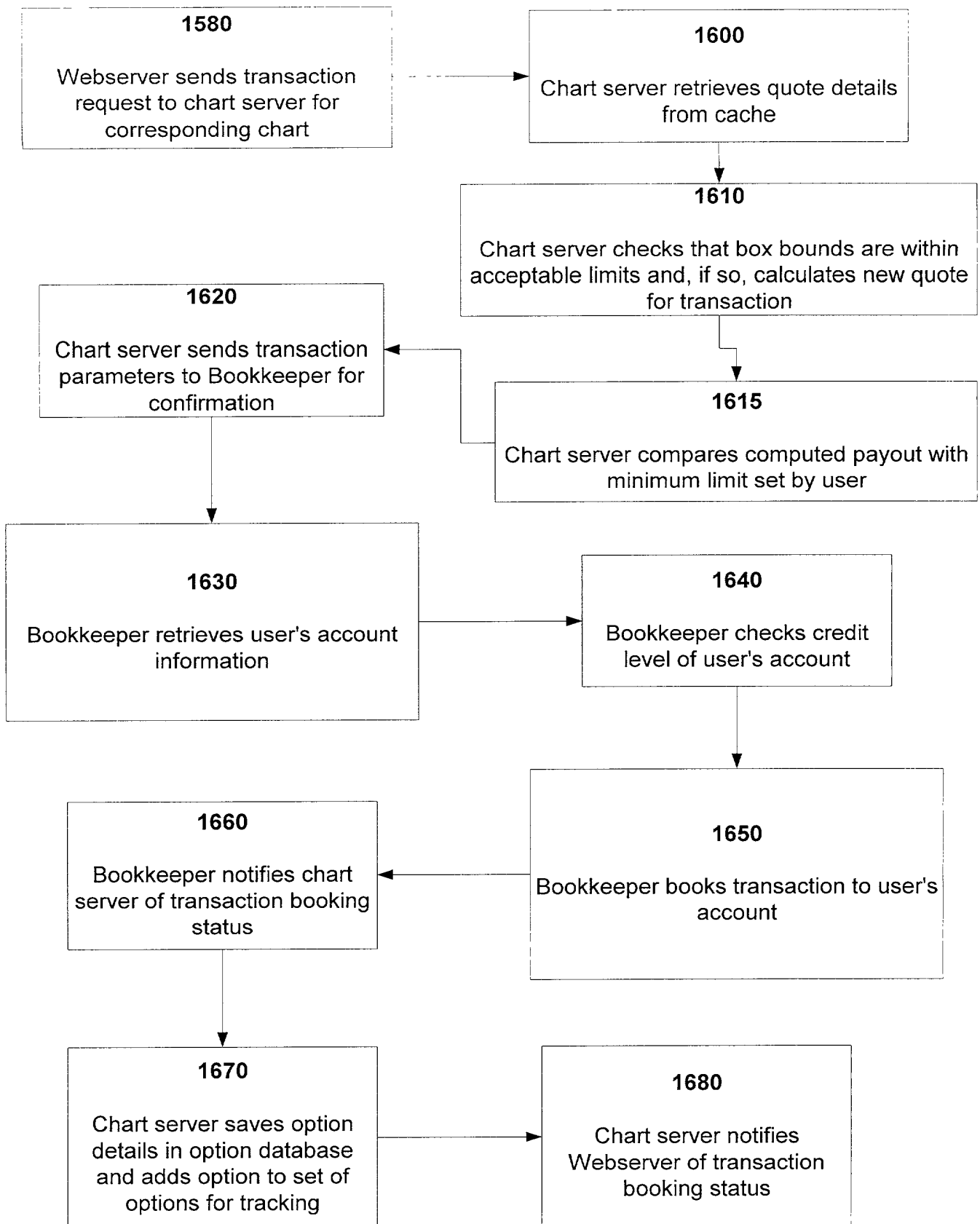




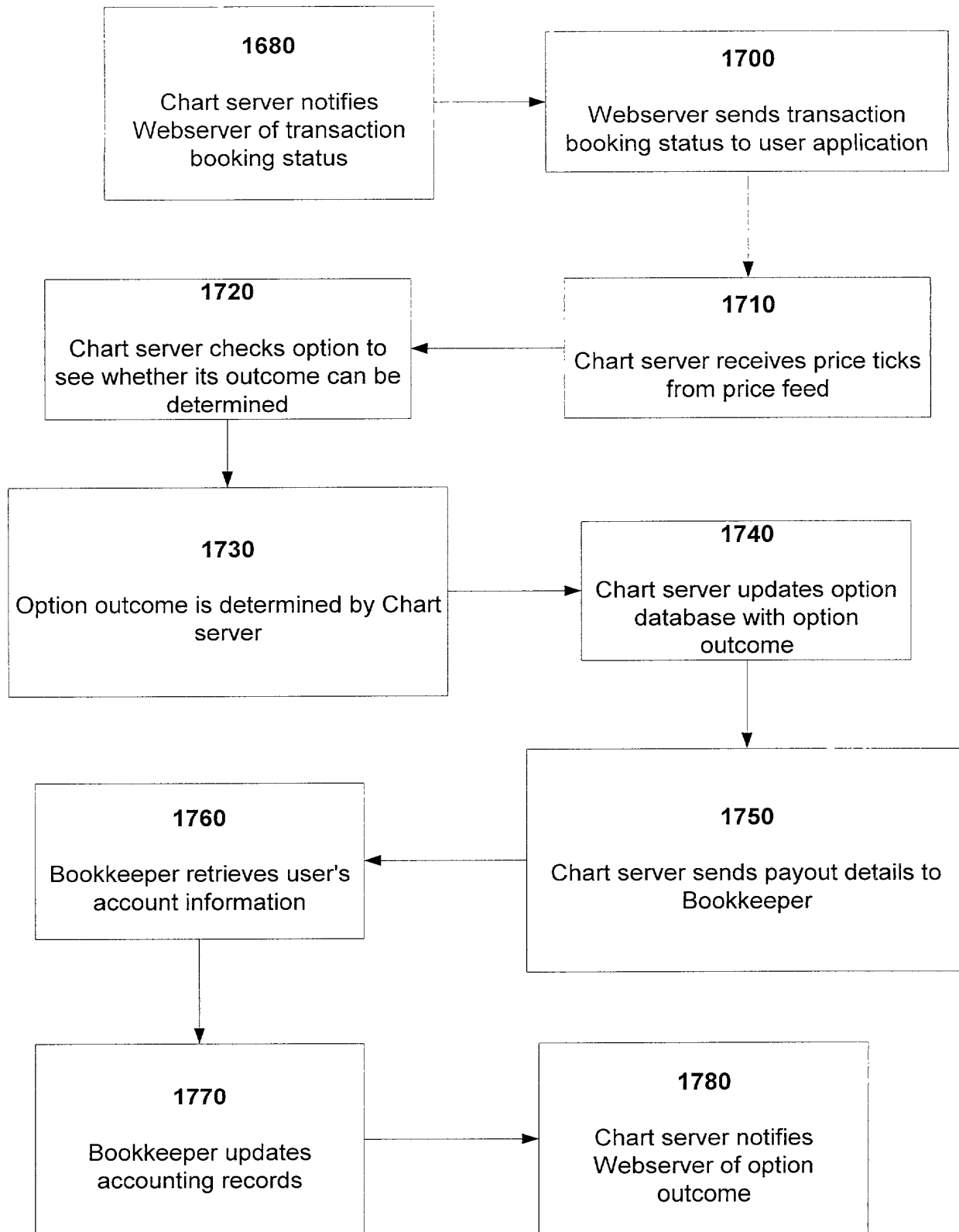
**FIG. 14**



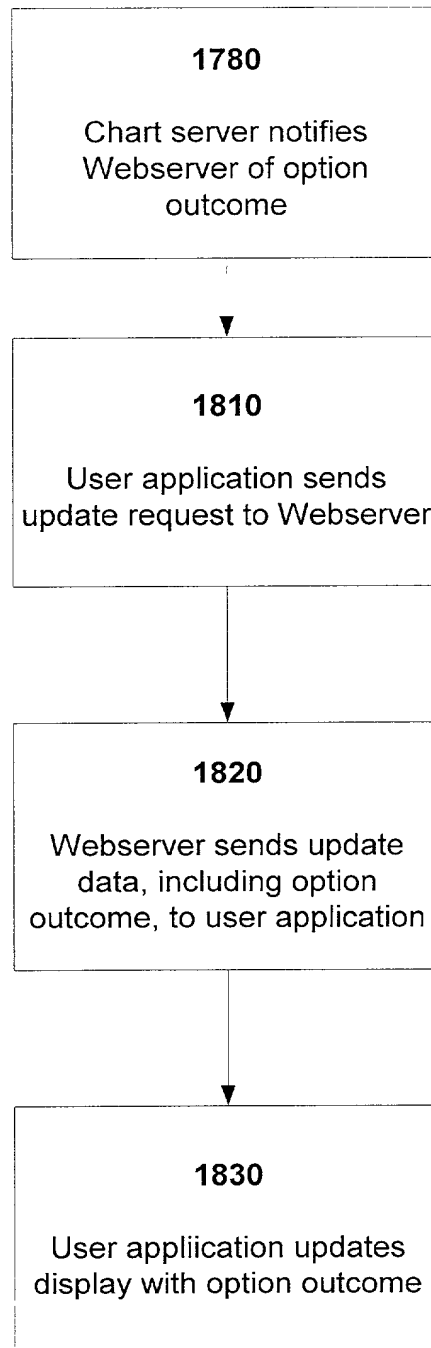
**FIG. 15**



**FIG. 16**



**FIG. 17**



**FIG. 18**

ChartWin booking

Chart: USD-CHF

Window bounds:

From: 13 Nov 2000 17:11:00 GMT+01:00

Up to: 13 Nov 2000 17:20:00 GMT+01:00

Maximum level: 1.7704

Minimum level: 1.7677

Aim for plot to HIT window

Aim for plot to MISS window

Stake: \$10

Notify out one by mail

Current payout level: \$11.30

Update

Lower limit: \$10.01

You receive a return payout if your chart window is successful, you lose your stake if not. The exact payout amount is determined at time of booking, constrained by the lower limit as set. DEMO MODE - booking is not for real!

Submit Cancel

Unsigned Java Applet Window

1905

1910

1915

1920

1935

1945

1925

1930

1950

1940

1900

FIG. 19



**DECLARATION FOR NON-PROVISIONAL PATENT APPLICATION\***

As a below named inventor, I hereby declare that:

My residence, post office address and citizenship are as stated below at 201 et seq. beneath my name.

I believe I am the original, first and sole inventor if only one name is listed at 201 below, or an original, first and joint inventor if plural names are listed at 201 et seq. below, of the subject matter which is claimed and for which a patent is sought on the invention entitled

**METHOD FOR CREATING AND PRICING OPTIONS**

and for which a patent application:

☒ is attached hereto and includes amendment(s) filed on *(if applicable)*

☐ was filed in the United States on as Application No. *(for declaration not accompanying application)*

with amendment(s) filed on *(if applicable)*

☐ was filed as PCT international Application No. on and was amended under PCT Article 19 on *(if applicable)*

I hereby state that I have reviewed and understand the contents of the above identified application, including the claims, as amended by any amendment referred to above.

I acknowledge the duty to disclose information known to me to be material to patentability as defined in Title 37, Code of Federal Regulations, §1.56.

I hereby claim foreign priority benefits under Title 35, United States Code, §119(a)-(d) of any foreign application(s) for patent or inventor's certificate listed below and have also identified below any foreign application for patent or inventor's certificate having a filing date before that of the application on which priority is claimed:

EARLIEST FOREIGN APPLICATION(S), IF ANY, FILED PRIOR TO THE FILING DATE OF THE APPLICATION			
APPLICATION NUMBER	COUNTRY	DATE OF FILING (day, month, year)	PRIORITY CLAIMED
			YES <input type="checkbox"/> NO <input type="checkbox"/>
			YES <input type="checkbox"/> NO <input type="checkbox"/>
			YES <input type="checkbox"/> NO <input type="checkbox"/>

I hereby claim the benefit under Title 35, United States Code, §119(e) of any United States provisional application(s) listed below.



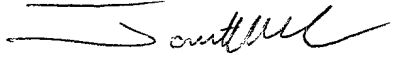
PROVISIONAL APPLICATION NUMBER	FILING DATE

I hereby claim the benefit under Title 35, United States Code, §120 of any United States application(s) listed below and, insofar as the subject matter of each of the claims of this application is not disclosed in the prior United States application in the manner provided by the first paragraph of Title 35, United States Code §112, I acknowledge the duty to disclose information known to me which is material to patentability as defined in Title 37, Code of Federal Regulations, §1.56 which became available between the filing date of the prior application and the national or PCT international filing date of this application:

NON-PROVISIONAL APPLICATION SERIAL NO.	FILING DATE	STATUS		
		PATENTED	PENDING	ABANDONED

\* for use only when the application is assigned to a company, partnership or other organization.

I hereby declare that all statements made herein of my own knowledge are true and that all statements made on information and belief are believed to be true; and further that these statements were made with the knowledge that willful false statements and the like so made are punishable by fine or imprisonment, or both, under Section 1001 of Title 18 of the United States Code and that such willful false statements may jeopardize the validity of the application or any patent issuing thereon.

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	SIGNATURE OF INVENTOR 201 			DATE 15 Nov 2000	
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	SIGNATURE OF INVENTOR 203 			DATE 15th November 2000	
204	FULL NAME OF INVENTOR	LAST NAME	FIRST NAME	MIDDLE NAME	
	RESIDENCE & CITIZENSHIP	CITY	STATE OR FOREIGN COUNTRY	COUNTRY OF CITIZENSHIP	
	POST OFFICE ADDRESS	STREET	CITY	STATE OR COUNTRY	ZIP CODE
	SIGNATURE OF INVENTOR 204			DATE	
205	FULL NAME OF INVENTOR	LAST NAME	FIRST NAME	MIDDLE NAME	
	RESIDENCE & CITIZENSHIP	CITY	STATE OR FOREIGN COUNTRY	COUNTRY OF CITIZENSHIP	
	POST OFFICE ADDRESS	STREET	CITY	STATE OR COUNTRY	ZIP CODE
	SIGNATURE OF INVENTOR 205			DATE	

**IN THE UNITED STATES PATENT AND TRADEMARK OFFICE**

Application of: Müller et al.

Application No.: Not yet assigned.

Group Art Unit: Not yet assigned.

Filed:

Examiner: Not yet assigned.

For: METHOD FOR CREATING AND  
PRICING OPTIONS

Attorney Docket No.: 10366-013

**POWER OF ATTORNEY BY ASSIGNEE  
AND EXCLUSION OF INVENTOR(S) UNDER 37 C.F.R. 3.71**

Assistant Commissioner for Patents  
Washington, D.C. 20231

Sir:

The undersigned assignee of the entire interest in the above-identified subject application hereby appoints: S. Leslie Misrock (Reg. No. 18872), Berj A. Terzian (Reg. No. 20060), David Weild, III (Reg. No. 21094), Jonathan A. Marshall (Reg. No. 24614), Barry D. Rein (Reg. No. 22411), Stanton T. Lawrence, III (Reg. No. 25736), Charles E. McKenney (Reg. No. 22795), Philip T. Shannon (Reg. No. 24278), Francis E. Morris (Reg. No. 24615), Charles E. Miller (Reg. No. 24576), Gidon D. Stern (Reg. No. 27469), John J. Lauter, Jr. (Reg. No. 27814), Brian M. Poissant (Reg. No. 28462), Brian D. Coggio (Reg. No. 27624), Rory J. Radding (Reg. No. 28749), Stephen J. Harbulak (Reg. No. 29166), Donald J. Goodell (Reg. No. 19766), James N. Palik (Reg. No. 25510), Thomas E. Friebel (Reg. No. 29258), Laura A. Coruzzi (Reg. No. 30742), Jennifer Gordon (Reg. No. 30753), Allan A. Fanucci (Reg. No. 30256), Geraldine F. Baldwin (Reg. No. 31232), Victor N. Balancia (Reg. No. 31231), Samuel B. Abrams (Reg. No. 30605), Steven I. Wallach (Reg. No. 35402), Marcia H. Sundeen (Reg. No. 30893), Paul J. Zegger (Reg. No. 33821), Edmond R. Bannon (Reg. No. 32110), Bruce J. Barker (Reg. No. 33291), Adriane M. Antler (Reg. No. 32605), Thomas G. Rowan (Reg. No. 34419), James G. Markey (Reg. No. 31636), Thomas D. Kohler (Reg. No. 32797), Scott D. Stimpson (Reg. No. 33607), Gary S. Williams (Reg. No. 31066), William S. Galliani (Reg. No. 33885), Ann L. Gisolfi (Reg. No. 31956), Todd A. Wagner (Reg. No. 35399), Scott B. Familant (Reg. No. 35514), Kelly D. Talcott (Reg. No. 39582), Francis D. Cerrito

POWER OF ATTORNEY

(Reg. No.38100), Anthony M. Insogna (Reg. No. 35203), Brian M. Rothery (Reg. No. 35340), Brian D. Siff (Reg. No. 35679), and Alan Tenenbaum (Reg. No. 34939), all of Pennie & Edmonds LLP, whose addresses are 1155 Avenue of the Americas, New York, New York 10036, 1667 K Street N.W., Washington, DC 20006 and 3300 Hillview Avenue, Palo Alto, CA 94304, all of Pennie & Edmonds LLP (PTO Customer No. ), as its attorneys to prosecute this application and to transact all business in the United States Patent and Trademark Office connected therewith, said appointment to be to the exclusion of the inventors and their attorney(s) in accordance with the provisions of 37 C.F.R. 3.71, provided that, if any one of these attorneys ceases being affiliated with the law firm of Pennie & Edmonds LLP as partner, counsel, or employee, then the appointment of that attorney and all powers derived therefrom shall terminate on the date such attorney ceases being so affiliated.

An assignment of the entire interest in the above-identified subject application:

☐ was recorded on \_\_\_\_\_ at reel/frame \_/\_\_\_\_\_.  
☒ is submitted herewith for recording.

Please direct all correspondence for this application to customer no. 20583.

ASSIGNEE: Olsen & Associates  
Signature: R. Olsen  
Typed Name: R. Olsen  
Position/Title: Partner  
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Switzerland  
Date: 15 March 2000